No. 446

SEP 24 1918

JAMES D. MAHONEY,
Clerk.

Supreme Court of the United States.

OCTOBER TERM, 1918. No. [redacted]

THE MECHANICS AND METALS NATIONAL BANK OF THE CITY OF NEW YORK,

Appellant,

vs.

IRVING L. ERNST, LINDSAY RUSSELL and HARFORD T. MARSHALL, as Trustees in Bankruptcy of DUDLEY P. HAMMERSLEY, et al.,

Appellees.

Appeal from the District Court of the United States for the Southern District of New York.

BRIEF ON BEHALF OF APPELLANT, THE MECHANICS AND METALS NATIONAL BANK OF THE CITY OF NEW YORK.

ADRIAN H. LARKIN,

Solicitor for Appellant.

ADRIAN H. LARKIN,
LEWIS H. FREEDMAN,
LELAND B. GARRETSON,
Of Counsel.

(20,000 words.)

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Supreme Court of the United States.

OCTOBER TERM, 1912.

No. 995.

THE MECHANICS & METALS NATIONAL BANK OF THE CITY OF NEW YORK,
Appellant,

AGAINST

IRVING L. ERNST, LINDSAY RUSSELL and HARFIELD T. MARSHALL, as Trustees in Bankruptcy of DUDLEY P. HUMPHREY *et al.*,
Appellees.

No. 995.

BRIEF ON BEHALF OF APPELLANT.

This is an appeal from a final decree rendered in the United States Circuit Court of Appeals for the Second Circuit on the 23d day of December, 1912, affirming a decree of the United States District Court for the Southern District of New York, entered January 9, 1912 (p. 520) (201 Fed., 664).

The decree of the District Court confirmed the report of a Special Master before whom the case was tried on consent of both

parties, after hearing upon exceptions, and decreed that certain transfers and deliveries of stocks, bonds, securities and moneys, made by the bankrupt firm of J. M. Fiske & Co. to the appellant on the 19th day of January, 1910, were unlawful preferences within the meaning of the Bankruptcy Act of 1898, as amended, and were void and should be set aside, and that the appellees, the Trustees in Bankruptcy of said firm of J. M. Fiske & Co., should recover from the appellant, the sum of $255,312.21, being the amount realized by the appellant from the securities, property and cash received by it, together with costs (pp. 351-353).

The questions involved in this appeal are as follows:

1. Whether the transactions between appellant and the firm of J. M. Fiske & Company on the 9th day of January, 1910, in view of the contract relations existing between them and in view also of the custom of the financial district in the City of New York, which the appellant claims governed said transactions, were such that the receipt by the appellant of the securities, property and cash so received by it on that day constituted such a payment as can be avoided and set aside on the suit of the Trustees in Bankruptcy, on the ground that an unlawful preference under the Bankruptcy Act was given and received.

2. Whether at the time the appellant received said securities, property and cash, the elements necessary to satisfy the requirements of Section 60 of the Bankruptcy Act to enable a Trustee in Bankruptcy to successfully maintain such a suit existed.

3. Whether the appellees have properly and by competent evidence established the existence of bankruptcy as a part of their *prima facie* case and as a condition precedent to their right to recover.

Statement of the Case.

On or about November 8th, 1901, the firm of J. M. Fiske & Company, who were stockbrokers in New York City, entered into an agreement in writing with The Mechanics National Bank of the City of New York, the name by which the appellant was known prior to January 29th, 1910, under which agreement the bank, from time to time, loaned the brokers divers sums of money. All loans subsequent to the making of said agreement were made with reference thereto (pp. 15, 111-112). Said agreement is as follows:

> KNOW ALL MEN BY THESE PRESENTS, That the undersigned, in consideration of financial accommodations given or to be given, or continued to the undersigned by the Mechanics' National Bank of the City of New York, hereby agree with the said Bank that whenever the undersigned shall become or remain, directly or contingently, indebted to the said Bank for money lent, or for money paid for the use or account of the undersigned, or for any overdraft or upon any endorsement, draft, guarantee or in any other matter whatsoever, or upon any other claim, the said Bank shall then and thereafter have the following rights, in addition to those created by the circumstances from which such indebtedness may arise against the undersigned, or his, or their executors, administrators or assigns, namely:
>
> 1.—All securities deposited by the undersigned with said Bank, as collateral to any such loan or indebtedness of the undersigned to said Bank shall also be held by said Bank as security for any other liability of the undersigned to said Bank, whether then existing or thereafter contracted; and said Bank shall also have a lien upon any balance of the deposit account of the undersigned with said Bank existing from time to time,

and upon all property of the undersigned of every description left with said Bank for safe keeping or otherwise, or coming to the hands of said Bank in any way, as security for any liability of the undersigned to said Bank now existing or hereafter contracted.

2.—Said Bank shall at all times have the right to require from the undersigned that there shall be lodged with said Bank as security for all existing liabilities of the undersigned to said Bank, approved collateral securities to an amount satisfactory to said Bank; and upon the failure of the undersigned at all times to keep a margin of securities with said Bank for such liabilities of the undersigned satisfactory to said Bank, or upon any failure in business or making of an insolvent assignment by the undersigned, then and in either event all liabilities of the undersigned to said Bank shall at the option of said Bank become immediately due and payable, notwithstanding any credit or time allowed to the undersigned by any instrument evidencing any of the said liabilities.

3.—Upon failure of the undersigned either to pay any indebtedness to said Bank when becoming or made due, or to keep up the margin of collateral securities above provided for, then and in either event said Bank may immediately without advertisement, and without notice to the undersigned, sell any of the securities held by it as against any and all of the liabilities of the undersigned, at private sale or Broker's Board or otherwise and apply the proceeds of such sale as far as needed toward the payment of any or all such liabilities together with interest and expenses of sale, holding the undersigned responsible for any deficiency remaining unpaid after such application. If any such sale be at Broker's Board or at public auction, said Bank may itself be a purchaser at such sale free from any right

or equity of redemption of the undersigned, such right and equity of redemption of the undersigned, such right and equity being hereby expressly waived and released. Upon default as aforesaid, said Bank may also apply toward the payment of the said liabilities all balances of any deposit account of the undersigned with said Bank then existing.

It is further agreed that these presents constitute a continuing agreement, applying to any and all future as well as to existing transactions between the undersigned and said Bank.

J. M. FISKE & Co.

Dated, New York, the 8th day of November, 1901.

(Defendant's Exhibit A, pp. 452-454.)

At the opening of business on January 19, 1910, the said firm of J. M. Fiske & Company had on deposit with the appellant the sum of $36,239.47, and appellant also held two promissory notes of said firm aggregating $55,000, the loans on said notes being secured by collateral deposited with and held by appellant (pp. 80, 103 and 104).

No issue has been raised as to the right of the appellant to set off said deposit against existing indebtedness, and no claim is made for proceeds of the sale of the securities constituting the collateral to the loans aggregating $55,000 (p. 103).

Before or about 10 o'clock A. M., on January 19, 1910, J. M. Fiske & Company delivered to the appellant a written request for a "day" loan, as follows:

"NEW YORK, January 19, 1910.

MECHANICS NATIONAL BANK,
New York City.

Please loan us today $400,000. Crediting this amount to our account, and oblige.

J. M. FISKE & COMPANY."

(p. 379.)

Upon receipt of this request, the appellant credited the said firm with said amount upon its deposit account (pp. 80, 280, 281). This credit was given subject to the agreement of November 8, 1901 (pp. 280 and 281), and it is the contention of the appellant that it was also given subject to the custom of the financial district in the City of New York governing "day" or "clearance" loans.

About 12 o'clock, noon, on said day the brokers deposited with the appellant checks amounting to $54,048.08, so that, including the balance of $36,239.47 standing to the credit of the firm at the opening of business, and the "day" loan made to it that morning, its account showed total credits on that day aggregating $490,287.55. During the same period the appellant certified and subsequently paid checks drawn by said brokers against their account amounting to $276,679.67 (pp. 81, 280 and 281).

Between 11 and 12 o'clock on January 19, 1910, Mr. Frank O. Roe, the Cashier of the appellant, was informed by a clerk in the department of the receiving teller that there was a disturbance in the stock market, some trouble on the Stock Exchange, and that it was rumored that J. M. Fiske & Company was in trouble (pp. 85 and 282). Upon hearing this rumor, Mr. Roe at once ascertained how much J. M. Fiske & Company had drawn on that day, and instructed the paying teller and certification clerk not to pay or certify any more checks for their account *until they should hear further from him* (pp. 87, 88 and 282).

He thereupon consulted with Mr. Knowles, one of the vice-presidents of the bank, told him that he heard the firm of J. M. Fiske & Company "was being talked about," and then went to the office of said firm at No. 42 Broadway, New York (pp. 88 to 90 and 282). Upon arriving at the office of the brokers, Mr. Roe asked for and saw

Mr. Sherwood, one of the members of the firm. This was somewhat before 12 o'clock noon (pp. 88 to 91 and 348). He told Mr. Sherwood that he had heard rumors about his firm; that the appellant had certified a considerable sum for their account on that morning, and that they, J. M. Fiske & Company, had not up to that time made a deposit. Mr. Sherwood replied that a deposit was then on its way to the bank. Mr. Roe did not ask, and Mr. Sherwood did not state the amount of this deposit (pp. 95-96). Mr. Roe then told Mr. Sherwood that he thought he had better give him some securities, whereupon Mr. Sherwood consulted Mr. Humphrey, one of his partners, who went into the cage in the office, got the securities set forth in Plaintiff's Exhibit 6 (p. 381), and gave them to Mr. Sherwood, who in turn handed them to Mr. Roe. Mr. Roe took the securities, glanced over them, put them in his pocket and went directly back to the bank. There was very little said between Mr. Roe and Mr. Sherwood. In reply to Mr. Roe's statement that rumors had come to the bank about the firm, Mr. Sherwood made no direct reply. The entire call lasted somewhat less than five minutes (pp. 92 to 97).

The deposit referred to by Mr. Sherwood arrived during the absence of Mr. Roe from the bank and amounted to $54,048.08 (pp. 80, 81, 110 and 348).

Upon returning to the bank Mr. Roe turned the securities over to the assistant cashier in charge of the Loan Department and instructed him to list them up, which was immediately done (p. 99). He also gave final instructions that the account of the brokers be closed and balanced, and it was found that they were indebted to the bank in the sum of $242,201.50, exclusive of the value of the securities received by Mr. Roe, and exclusive of the indebtedness and interest due on the collateral loans aggre-

gating $55,000 of principal (pp. 101, 102, 104 and 283).

The securities thus obtained by Mr. Roe were subsequently sold by the appellant for the account of the loan and realized $175,647.45 (pp. 100, 276-7, 283 and 381).

It is for the recovery of said deposit of $54,048.08 and the proceeds of said securities amounting to $175,647.45, that this suit was brought.

From Appendix A, attached hereto, it appears that all of the securities delivered by Mr. Sherwood to Mr. Roe, with the single exception of 10 shares of Interboro Metropolitan Co. common stock, had come into the possession of the brokers by the direct use of the $400,000. credit given that morning. It further appears that upon the qualification of the Receivers in Bankruptcy certain other securities came into their possession as a part of the bankrupt estate (p. 128; Plaintiff's Exhibit 7, p. 382).

At 12.40 o'clock P. M. on January 19, 1910, J. M. Fiske & Company gave notice to the New York Stock Exchange of their inability to meet their obligations (Plaintiff's Exhibit 3, p. 379).

At 3.25 o'clock P. M. on said day an involuntary petition in bankruptcy was filed against the said firm and the individual members thereof in the District Court of the United States for the Southern District of New York (Plaintiff's Exhibit 10, p. 394). On March 12, 1910, they were adjudicated bankrupts (Plaintiff's Exhibit 1, p. 375). On May 7, 1910, the bond of the appellees as trustees in bankruptcy was duly approved (Plaintiff's Exhibit 2, p. 378).

For some time prior to the date of the filing of this petition, the firm of J. M. Fiske & Company were and had been members of two certain pools organized, as is stated in the pooling agreements, for the purpose of purchasing in all 40,000 shares of

the common stock of the Columbus and Hocking Coal & Iron Company (Defendant's Exhibits C, D, E, F and G; pp. 471 and 474). In the first of these pools the firm had subscribed for 2,000 shares (Defendant's Exhibit D, p. 477), and in the second for 4,000 shares (Defendant's Exhibit F, p. 474). One James R. Keene was manager of both said pools (Defendant's Exhibit C, p. 477).

At the time of their failure, J. M. Fiske & Company were carrying either for their customers or for their own account, either as members of the pool or otherwise, 9,740 shares of Columbus and Hocking Coal & Iron Company common stock (p. 172). Of this amount, the firm's participation at the time as a member of these pools amounted to 3,300 shares, as shown by the "Four-Fourths" account (pp. 50, 173; Plaintiff's Exhibit 19, p. 402), the remaining 6,440 shares being carried for customers. For a week prior to January 19, 1910, this stock was sold on the New York Stock Exchange between 91¾ and 87¼, and opened on that day at 88½. Its fluctuations on that day covered a range of over 60 points, selling as low as 25, and eventually closing at 37 (p. 272). The result of this fluctuation was to cause a panic in this stock (p. 162). For the purposes of this suit, the value of this stock is taken at 60 (pp. 166-170, 286).

What he believed to be the reason of this fluctuation is testified to by Mr. Ernst, one of the trustees in bankruptcy. His testimony best expresses his belief:

> "I felt that Mr. Keene violated his duty as syndicate manager for the Hocking Pool. I felt that he traded in stocks of the Hocking Company as an individual to his own profit, in violation of his rights and duties as manager of the syndicate. I believe that he went short of the market when he knew, or had reasonable cause to believe, that there was going to be a drop in the market of that

> stock. I believe he sold his own stocks to the syndicate, and sold short stock, and delivered some of his own long stocks to the syndicate at high prices, and covered his transactions at bottom prices" (p. 135).

As the result of this belief the trustees in bankruptcy brought two suits against Mr. Keene, the pleadings of which are in evidence (Defendant's Exhibits H, I, J and K, pp. 475-511).

In regard to the transaction out of which the alleged cause of action arose, the appellant's answer, after denying that it was an unsecured creditor of said firm of J. M. Fiske & Co., in the sum of $500,000.00 as alleged in the bill of complaint, pleads the contract of November 8th, 1901, and claims that it was entitled to said deposit and said securities under said contract as governed by the general usage which prevailed in such transactions in the financial district in New York City. It is also denied that at the time of the receipt of said cash and securities the appellant knew or had reasonable cause to believe that the bankrupts were insolvent or that it was intended to give or receive any preference (pp. 15-22).

According to the general custom prevailing among stock brokers dealing through the New York Stock Exchange securities sold on one day are deliverable on the next business day, payment being made therefor on delivery. It frequently happens that securities sold by a broker have been placed by him as security for loans, and to obtain such securities for delivery the broker is obliged to pay off such loans, or at least so much thereof as is sufficient to release the securities he wishes to deliver. In order to obtain funds to pay such loans and release the securities sold, or to pay for stocks and bonds purchased, so as to make delivery to those to whom they have been sold, or for whose account they have been purchased, either

cash or credit from the banks is absolutely necessary (Op. Ward, Circuit Judge, p. 516). The transactions are of such exceptional magnitude that it would not be possible to conduct the business either on a cash basis or with the private capital of the brokers engaged in it (Report of Special Master, p. 299).

The necessity for these "day" loans is explained by the Special Master. As he points out, brokers are able to pay for securities which they have purchased only by the proceeds of the securities which they sell. Deliveries of purchases and sales proceed simultaneously, consequently the broker in view of the magnitude of the volume of business and the limitations of private capital is obliged to obtain temporary funds to pay for securities deliverable to him while he is receiving the proceeds of the securities which he is delivering to his purchasers. Business must be done between 10 A. M. and 3 P. M., and it is impossible for any one broker to so arrange his business that he may make deliveries upon his contracts to sell before deliveries under contracts to purchasers are made to him. While, therefore, it is necessary for the broker to have financial assistance in the shape of a "day" loan to pay for stocks delivered to him, it is equally necessary that he have the use of the stocks delivered to him so as to make deliveries himself, and this the banks making the loan permit him to do. With the net results of the proceeds of his entire clearance he pays the "day" loan in one or the other of the manners described above (pp. 299 and 300).

In order to meet the very apparent exigencies of the business by supplying to the brokers a temporary credit sufficient to their needs, a general custom exists among brokers and their respective banks whereby each day the bank makes a loan to the broker who is its customer, which loan is known as a "day" or "clearance" loan. Such loans are made

without interest and are payable at or before the close of business on the day on which they are made. This loan is made each morning and is passed to the credit of the deposit account of the broker requesting it. The evidence of the indebtedness varies somewhat with the various banks, in some insititutions the broker delivering to the bank a demand note, in others, as in the case at bar, a mere request to loan, which is supplemented, however, by a loan agreement similar to that in evidence herein (Report of Special Master, pp. 279, 280 and Defendant's Exhibit A, p. 452).

The loan having been made and the credit given to the broker upon the bank's books, the broker proceeds to the transaction of his day's business, delivering his checks drawn against the proceeds of the loan thus obtained, either to pay off loans and release securities which he is under obligation to deliver, or else to pay for securities which he has contracted with other brokers to receive. Sometimes a broker may receive and pay for securities with the proceeds of the "day" loan, and taking the securities thus acquired, make another loan upon them as collateral and use the proceeds thereof in the further transaction of his business. As soon as the broker delivers the securities thus released and obtains payment therefor, or hypothecates securities purchased and obtains the proceeds of the collateral loan made thereon, the checks given either by the customers, the brokers, or the bank or trust company making the collateral loan, as the case may be, are deposited in the general account of the broker in the bank with which he has made the "day" loan. These deposits often begin to come into the bank within a few moments after the stock market opens in the morning and the broker is expected to make the deposits as quickly as he receives his checks (pp. 113-116, 244, 266, 268, 294 and 295).

If, in the course of the day's business, the broker

has received therefrom and has deposited in his account, checks aggregating an amount equal to or greater than the amount of his morning "day" loan, he draws against the account a check for the amount of the said "day" loan and delivers the same to the bank. For this he receives his note marked "paid" and the check thus given going through the books as a charge is debited to his account, thus cancelling the credit of the morning and the loan is thus paid (pp. 218, 294 and 295). If on the other hand, the broker's transactions during the day have so depleted his bank balance that he has not in bank an aggregate amount sufficient to repay the "day" loan, the broker takes securities released to him by the use of the money advanced as the "day" loan and negotiates a collateral loan either with some other bank or person, or else an independent collateral loan is sometimes negotiated with the bank which has made the "day" loan. In any event, the collateral loan being made, the broker would take the proceeds thereof, and depositing the same in his account with the bank which had made the "day" loan, would draw his check for the amount of the "day" loan against his reinforced balance and deliver the same to the bank. The check goes through the broker's accounts on the books of the bank cancelling the credit given in the morning, as above described, thus paying the "day" loan.

Should the broker be unable to make a collateral loan, recognizing the lien of the bank upon the securities cleared by the use of the proceeds of the "day" loan, to the possession of which at any time during the day the bank is entitled, he actually delivers the securities so cleared by the proceeds of the "day" loan to the bank as security for his indebtedness (pp. 518-519).

The reason the banks have come to prefer the

broker to make a collateral loan and deliver them the proceeds under such circumstances as last described, rather than taking securities directly, so as to reduce to possession the security which would protect the deficit in the "day" loan, is explained by Mr. Alexander. "Day" loans do not draw interest and collateral loans do and the banks regard it solely as a matter of good business to have their money drawing interest over night (p. 254).

In spite of the finding of the Special Master to the contrary (p. 297) the record shows two instances in which the firm of J. M. Fiske & Company made collateral loans with the appellant, on security purchased by the use of the bank funds and depositing the proceeds of these loans to their credit, drew their check against their balance thus enlarged to pay the "day" loan (Plaintiffs' Exhibits 23 and 27, pp. 403-415, 418-426). One of these loans, one amounting to $5,000, was made on January 7, 1910, and was secured by 100 shares of Wabash Ry. Co. preferred stock and 20 shares of United States Steel Corporation common stock (pp. 405, 419), and one amounting to $15,000 was made on January 18, 1910, and was secured by 200 shares of United States Steel Corporation, common stock, 10 shares of stock Sheffield Steel and Iron Company, common stock, and 10 shares of Chicago & Alton Ry. Co. common stock.

The 100 shares of Wabash Ry. Co. preferred (Ctf. 20346) were received January 7th, 1910, from Franke, Thompson and Robb against the delivery to them of J. M. Fiske & Co.'s check No. 59125 drawn on the appellant; the 20 shares of the United States Steel corporation common (Ctf. F 254435) were received from Carlisle, Mellick & Co. against check No. 59120; the 200 shares of United States Steel Corporation common (Ctfs. G 324961/2), hypothecated January 18th, 1910, were received

partly from H. N. Whitney and Son and partly from B. L. Smyth & Co. against checks Nos. 59482 and 59483, and the 10 shares of Chicago and Alton Ry. Co. common (Ctf. A 1387) were received from C. M. Schott, Jr. & Co. against check No. 59478 (pp. 404-5, 419-20).

The 10 shares of Sloss Sheffield Steel and Iron Co. common (Ctf. B 7244) were received by the brokers from transfer on January 11, 1910, and were taken from their "Box" on the day of its hypothecation (pp. 404-5). The record is not extensive enough to permit of its being traced to its original acquisition by the brokers.

Mr. Alexander also testified to an instance where a similar *modus operandi* was followed (p. 252), and Mr. Carse, on cross-examination, recalled a like transaction at the Hanover National Bank, but was not asked for any details (p. 230).

Assignments of Error.

(Record, pp. 522-528.)

The assignments of error to the Circuit Court of Appeals may be treated in groups.

1st to 4th inclusive. The Court erred in affirming the decree of the District Court, awarding costs against the appellant, and remanding the cause to the District Court with directions that the decree of January 9th, 1912, be affirmed.

5th. The Court erred in holding that the transfer and delivery by the firm of J. M. Fiske & Co. of the stocks, bonds, securities and moneys referred to in the bill of complaint, to the appellant on January 19, 1910, were and are unlawful preferences within the meaning of the Bankruptcy Act and are void, and in setting aside the said transfers and deliveries.

6th to 8th inclusive. The Court erred in holding that there was competent proof of the financial status of J. M. Fiske & Co. and the individual members thereof at the time of the delivery of the securities to the appellant's representative on January 19, 1910; and in holding that the books of J. M. Fiske & Co. were admissible as competent, material and relevant evidence to prove the insolvency of said firm, and that the same were properly proved.

9th and 10th. The Court erred in holding that at the time of the receipt by the appellant of the several items of securities and cash it had reasonable cause to believe that the firm of J. M. Fiske & Co. and its individual members were insolvent.

11th to 21st inclusive and 33d. The Court erred in holding that on the facts as revealed by the record and as found by the Special Master and District Judge the appellant must be deemed in law to have had sufficient knowledge of the fact that said firm was insolvent, and that having such knowledge, to have had reasonable cause to believe when it received such transfer that the fact of the transfer would have been to enable it to obtain a greater percentage of its debts than any other creditor of the same class.

23d, 30th, 31st and 44th. The Court erred in failing to hold that the appellant had an enforceable equitable lien or claim or right to or in the property, cash and securities received by it on January 19th, 1910.

22d and 24th to 29th inclusive. The Court erred in its construction of the contract between the appellant and the firm of J. M. Fiske & Co. and in its failure to read said contract in accordance with the

custom of the financial district in the City of New York as revealed by the record.

32nd. The Court erred in holding that the fact as found by the Special Master and by the District Court of the United States was that the common stock of the Columbus and Hocking Coal and Iron Company did not have any substantial value on January 19, 1910, and that its price was maintained by a pool organized to inflate it.

34th and 35th. The Court erred in holding that the appellant is a general creditor of the said firm of J. M. Fiske & Co.

36th to 39th inclusive, 42nd and 43rd. The Court erred in holding that a condition did not exist out of which any custom or usage whereby the making and payment of "day" or "clearance" loans was governed, and in failing to hold that the custom or usage did in fact exist and that "day" or "clearance" loans made by and between banks and stock exchange brokers in the City of New York, N. Y., were governed by said custom which was shown by the record to exist as a matter of fact.

40th and 41st. The Court erred in holding that the result of the day's transactions leads to the payment of the "day" loans and not to their security and that such is the understanding and intent of both borrower and lender, and in its failure to hold that the intent of both borrower and lender is to secure said "day" loans at the time they are made, and that the same shall remain secured at all times until paid, and that the lender shall from the time the loan is made have a lien or claim upon or interest in said funds and the avails thereof, no matter what form they shall take, until the payment and discharge of said "day" loans.

45th and 46th. The Court erred in holding that the appellant had no right to retain the sum of $54,048.08 constituting the deposit made by J. M. Fiske & Co. on January 19, 1910.

47th and 48th. The Court erred in holding that the appellant never received said deposit as a bank and that said firm of J. M. Fiske & Co. never had the right to draw against said sum, and in failing to hold that the relation of banker and depositor was established between the appellant and said firm and remained absolute until the time of the failure of said firm, subsequent to the time of the making thereof, when the right of set-off was exercised by the appellant pursuant to the agreement existing between the said appellant and said firm of J. M. Fiske & Co., and pursuant to its rights as a bank to which its depositor is indebted.

49th to 53rd, inclusive. The Court erred in holding that the deposit of said sum constituted a preferential payment by the said firm of J. M. Fiske & Co. to the appellant, under the Bankruptcy Act of 1898, as amended, that when said deposit was received the appellant had reasonable cause to believe that it was intended by said firm of J. M. Fiske & Co. to give the appellant a preference, that the appellant treated said deposit of $54,048.08 as a partial payment of the indebtedness of J. M. Fiske & Co., and that the transfer of said sum was void and that the appellees are entitled to set the receipt of said sum aside in accordance with the prayer contained in their bill of complaint.

POINTS.

FIRST POINT.—Under the agreement of November 8th, 1901, as amplified and modified by the general custom, which was proven, the appellant acquired an equitable lien upon, or right in or to the money constituting the "day" or "clearance" loan and in or to all securities or proceeds of whatever nature realized, cleared or obtained possession of by J. M. Fiske & Co. by the use of the said "day" or "clearance" loan in so far as such securities or proceeds were or could be identified as so realized, cleared or reduced to possession.

I.

"Day" or "Clearance" Loans.

On November 8, 1901, the firm of J. M. Fiske & Company and the appellant's predecessor entered into a certain agreement. (Defendant's Exhibit A, p. 452.) In connection with that agreement and as part of the contract made between the parties for conducting business between themselves, the so-called "day" or "clearance" loans were made for the purpose of extending credit to the brokers by means of which they could clear their securities and obtain possession thereof for delivery to their various customers (pp. 111-2; 219-220; 236, 262-70 and 280).

These "day" or "clearance" loans were a matter of daily occurrence from the date of the agree-

ment up to and including January 19, 1910 (pp. 81, 85).

On the morning of each business day the brokers sent to the bank a *written* request for a loan, which request was substantially as follows, differing only as to the date and amount of the loan requested.

"NEW YORK, , 19 .

MECHANICS NATIONAL BANK,
New York City.

Please loan us today $. Crediting this amount to our account and oblige,
J. M. FISKE & COMPANY."

The form of these notes as used among the several banks making such loans varied somewhat. Some institutions required demand notes while others used requests to loan similar to the one quoted above (pp. 247; 262-266). In one form or another, however, a loan agreement similar to the one in evidence was always an integral part of the transaction (pp. 279-80).

Pursuant to the written request thus made the bank would credit the account of the broker with the amount requested, thus increasing the amount on deposit to his credit by the amount of said "day" loan. Against his account the broker would then draw and have certified his checks, which checks were used by the broker either for the purpose of clearing or obtaining possession of securities which he was under an obligation to deliver to his customers on that day. As soon as the broker delivered the securities and obtained payment therefor, the checks given by the customers or other brokers in payment for securities delivered would be deposited by the broker with the bank in the broker's account. These deposits often began to be made within a few moments after the delivery of securities commenced at 10 o'clock in the morning, at which time the Stock Exchange

also opened, and the broker was expected to make the deposits as quickly as he received them. In many cases where the agent of the broker or so-called "runner" delivered the securities to the customer or for the benefit of the customer and received payment therefor, the check received by him was taken by the "runner" directly to the bank and deposited to the broker's credit without being taken to the broker's office (pp. 113-4, 115, 217-8, 221, 227, 232, 236, 243-4, 250, 266-8).

While no independent account was kept in which the "day" or "clearance" loans were credited separately from the broker's general account, it was expected and understood that no portion of such credit was to be used for any purpose other than to clear securities, although the broker was at liberty to draw against the balance standing to the credit of his account in excess of that derived from said "day" or "clearance" loan to pay the general expenses of his business and to meet the general obligations thereof (pp. 255, 266-7).

The "day" or "clearance" loan was paid and satisfied each day and no interest was charged thereon by the bank (pp. 233-4).

If at the time of the ending of the day's business at three o'clock the broker had deposited in his account checks aggregating an amount sufficient to repay the "day" loan he would draw against the account a check for the face amount of the loan and deliver the same to the bank. This check would be debited to his account and the loan thus paid (pp. 218, 236, 267-8).

If the amount of checks deposited by the broker in his account during the day did not aggregate an amount sufficient to repay the "day" loan, the broker would take the securities released by the use of the money advanced by the bank, constituting a part of the "day" loan, and negotiate a collateral loan with some other third person, or an independent colla-

teral loan would be negotiated with the bank itself. The broker would be paid the proceeds of the collateral loan, depositing with the person or institution making the loan sufficient collateral to secure the loan. On this loan he would be charged and be compelled to pay interest. The proceeds of the collateral loan would then be deposited in the account of the broker with the bank, and after such deposit the broker would have in his account sufficient funds to repay the "day" or "clearance" loan. He would then draw against his account thus reinforced a check for the face of the "day" or "clearance" loan and thus pay and cancel the same (pp. 83-4, 119, 121, 222, 230, 240-241, 253-4, 268).

It is the contention of the appellant that the evidence also shows that if the broker has not deposited sufficient checks representing securities cleared by the "day" or "clearance" loan to repay the same, or is unable to negotiate a collateral loan on such securities so that he may use the proceeds thereof to pay off the "day" loan, recognizing the lien of the bank created under the agreement between it and the broker and its right to the possession of the securities obtained by reason of the use of the money advanced by the bank in the morning for the so-called "day" or "clearance" loan or any portion of it, he delivers the same to the bank.

While it is true that in some cases inquiry is made as to just what securities the broker expects to clear, this practice is generally abandoned after the borrower has clearly established his credit on a satisfactory basis (pp. 224, 232-233). These "day" loans, once the line of credit is established, are based on the average daily requirements of the broker as determined by his average course of business (pp. 238-239). When a new account of this sort is opened, the banks inquire very thoroughly into the membership of the firm, the amount of capital in their business, the character of the

business which they expect to do and the nature of the securities they anticipate dealing in, and with whom they expect to deal (pp. 224-5, 232-3). The reason for this is explained by Mr. Alexander, who testified:

> "We are making advances to put them in possession of these very stocks; if they couldn't deliver they might have to come back and deposit the securities with us; it might be a forced over-night loan, and we would want to know whether they were such collateral as we would loan on. * * *
>
> We are looking to the collateral back of these daily clearance notes to the same extent that we are looking to the collateral back of our over-night loans; the basis in the bank is exactly similar" (p. 239).

II.

Evidence of the agreement under which the loan was made.

The method of doing business between the appellant and J. M. Fiske & Co. was governed by the agreement entered into between the parties evidenced in part by Defendant's Exhibit A (pp. 452-454) and by the general custom, which we submit was proven.

The general custom was proven by Mr. Roe on his cross-examination (pp. 113-121); Mr. Carse, one of the Vice-Presidents of the Hanover National Bank (pp. 217-234); Mr. Alexander, who held a similar office in the National Bank of Commerce (pp. 234-261), and the stipulation entered into (pp. 262-270).

Mr. Roe was specifically asked, and stated that there was a custom prevailing in relation to these "day" loans that was different from that which was expressed in the agreement, Defendant's Ex-

hibit A (pp. 112-115). The agreement by its very terms gave to the bank certain rights "*in addition to those created by the circumstances from which such indebtedness may arise*" (p. 452). He also testified that it was customary for the brokers to cover their "credit" or "day" loans as fast as checks were received by the broker, such checks being those which were received upon the delivery of stocks, meaning the stocks taken up (pp. 115-116), and again that the custom was for the brokers to make deposits at the bank as soon as their checks are received, or else to deposit "the securities to cover the amount of the advance made for the purpose of clearing their stocks" (p. 115).

MR. CARSE, in stating the difference between a "clearance" and "demand" loan, testified:

> "The rule is that loans are not made to Stock Exchange houses without collateral. The nature of their business is such that the thing which is paid for with the money which is loaned them is in shape to deliver to the lender, and so the lender requires it in the form of securities as collateral; so that on ordinary loans to run for any length of time they are always secured by collateral. In the case of these loans, as the collateral is in transit—that is to say the broker has to deliver it to someone else to get money to repay the loan, it has developed a form of a trust, and the clear understanding implied between the broker and the bank is that whatever the broker obtains by the proceeds of the loan given to him is held in trust for the account of the bank, and is to be accounted for during that day, it being clearly understood that in no case shall this accommodation run beyond the day on which it is granted. If a broker pays for stocks or bonds, it is the understanding of the bank that they belong to them as collateral to their loan, and the broker simply retains possession of them long enough to make de-

> livery and get payment; if the proceeds of the credit are used to pay for loans which are already secured by collateral, the bank expects that collateral to be placed in another loan, which might either be made with them or with some other institution, and the proceeds of that loan would be for this temporary loan, as we generally call it. These things are known as temporary day loans for the purpose of clearing the broker's business" (pp. 219-220).

He also testified:

> "The understanding is that they shall pay for these loans with good certified checks, and not by forcing loans on the bank; but there have been cases in times of stress where the broker has not been able to arrange the loans and so he has brought into the bank the securities which were paid for by the credit given to him, and the bank has made him a separate loan on that, and with that loan paid off the temporary loan which had been made in the morning" (p. 222),

and also that the understanding to which he referred was the ordinary usage and ordinary method of doing the business (p. 222).

And again:

> "If the securities which a broker intends to clear are not such securities that we would accept as collateral to a regular call loan, we refused to grant the accommodation for clearing them, the idea there being that the security for our money is the thing which is being paid for by our credit, and we want to have something to make that advance secure" (p. 225),

and when asked the following question made the following answer:

> "Q. Suppose you found one of these stock exchange houses using the proceeds of one of

> these clearance loans for purposes other than making his clearances, would that influence your conduct in dealing with him in the future?
>
> A. We would stop the accommodation at once, and if this were discovered before checks had been certified, we would refuse to certify the checks" (p. 226).

On cross-examination he testified that he recalled an occasion where the "day" loan was not paid and the bank, taking the securities made a collateral loan on them and used the proceeds to pay off the "day" loan (p. 230).

MR. ALEXANDER testified that the bank wanted to know the character of securities in which the broker dealt, saying:

> "That is the vital thing, because we are making the advance to put them in possession of these very stocks; if they couldn't deliver, they might have to come back and deposit the securities with us; it might be a forced over-night loan and we would want to know whether they were such collateral we would loan on. We would not know the securities they had were securities we would be willing to loan on" (p. 239).

On cross-examination he testified where a "day" loan was not paid during the day as follows:

> "I got a trust receipt that night for the securities he had in the vault; then I made a regular loan against the particular trust receipt and cleaned up that day loan" (pp. 252-253).

And that the reason why the securities themselves were not delivered was for the reason that the broker said he could not get them and therefore obtained and gave to the bank a trust receipt specifying the securities.

His reason for making the collateral loan rather than allowing the "day" loan to run over night is manifest: "Day loans do not carry interest, and I wanted to get the one day's interest" (pp. 252-254).

The stipulation between the parties is cumulative and states:

> (*a*) "That the said day or clearance loans were paid off by his [the broker's] check or checks drawn to the order of the bank, at the close of the day. That during the day, as soon as checks were received by him from the sale of securities cleared by the proceeds of the day or clearance loan, or as soon as moneys were received by the broker from new loans made with the securities cleared by the day or clearance loan, the checks or moneys resulting therefrom were promptly deposited with the bank during the day as soon as or within a reasonable time after the same were received; and that in order to pay off such day or clearance loans, if he had not sufficient funds on deposit with said bank which made such day or clearance loans, it would be necessary for him to obtain a demand or time loan at the Stock Exchange or from some bank or banker for that purpose. It sometimes happened that some loans were effected through brokers on the Stock Exchange for and on behalf of the identical bank making the day or clearance loan as aforesaid. The collateral security used for such demand or time loan might be any or all securities in his (the broker's) possession from whatever source and howsoever those securities were acquired by him; or he, the broker, might, if occasion required, apply directly to the bank making the said day or clearance loan for a new demand loan on such securities in his possession as aforesaid, as would be acceptable to the bank, in order to discharge his indebtedness under the day or clearance loan at the close of the day. The amount of such loan would be credited to his general account with the bank and the so-called day or clear-

ance loan would be paid at the close of the day by check drawn against this account" (pp. 267-268).

(*b*) "But it was expected and understood that no portion of the proceeds of the day or clearance loan was used for any purpose other than to clear securities" (p. 267).

(*c*) "If the officers of the Mechanics & Metals Bank and other banks doing this day or clearance loan business by means of a continuing loan agreement and a request to loan, were called they would testify that this day or clearance loan business was done in this manner and that they would testify the loans were liquidated in the same manner as they were in the banks where they were made upon a demand note, and that the stipulation with respect to the testimony of Messrs. Carse and Alexander and other witnesses apply as far as the liquidation and payment of the loans are concerned; and that the credit to the borrower from the bank under the system adopted by the Mechanics & Metals Bank and other banks using that system or form of business is in the same general manner as testified to by Messrs. Carse and Alexander" (pp. 269, 270).

From the stipulation it further appears that had other bankers been called they would have testified substantially in the same manner as Messrs. Carse and Alexander and that if members of stock exchange houses to whom the banks made the "day" or "clearance" loan had been called they would have also testified in the same manner (pp. 262, 266).

The Special Master found that this testimony failed to show the existence of any custom by which the securities obtained with the proceeds of the "day" loans were pledged as security for any part of such loan. The learned District Judge, after stating the appellant's position, correctly analyzes the evidence apart from Mr. Carse's testimony (p. 338) and in discussing that portion of the proof, he con-

cedes that it supports the appellant's contention, but disregards it, stating that he does so for two reasons:

1. It is "incompetent since it, in effect, usurps the Court's function, which is to decide what was the 'clear understanding'" (p. 343).

2. "When, therefore, Carse says what is the clear understanding of the legal effect of the practise, it is of no consequence, since that understanding was expressed only in acts, the natural meaning of which does not imply any trust relation, as he, and perhaps they, may have supposed. Had they said that they meant to create a trust, such a trust would arise, but when they merely adopted a course of conduct, the supposed results of that conduct are immaterial" (p. 344).

We submit that the construction of the learned District Judge is entirely too narrow.

A reading of Mr. Carse's testimony shows that while he used the expression "it was the clear understanding" (p. 221), he was testifying to what the parties had agreed was to be done. He unfortunately uses the language which a layman generally employs in attempting to describe what transpires between two persons, who are making an oral contract. His testimony was in effect the same as though he had stated that when application was made for the "day" or "clearance" loan, the officer of the bank to whom such application was made had said to the broker applying for such "day" or "clearance" loan that the money would be advanced and credited to his account if the broker would agree;

(*a*) that he would use the proceeds for the sole purpose of clearing securities;

(*b*) that the bank was to have a lien upon all securities of which the broker obtained possession by the use of said moneys, or the avails thereof, or

the right to have such securities or their proceeds used in the repayment of said "day" loans;

(*c*) that in the event of repayment not being made, the same day, either by sending around sufficient deposits or by providing sufficient moneys by procuring the usual Stock Exchange collateral loans, the specific securities, possession of which had been obtained by the broker by the use of said moneys, would be held by said brokers for the benefit of said bank or deposited with said bank; and that after such statement had been made by the representative of the bank, the broker had said that he agreed to it.

Furthermore, the testimony introduced on behalf of the appellant shows that for a long period of time, J. M. Fiske & Co. had carried on this business by the use of the moneys furnished by the bank in a certain way which was well known to the bank, and thus established a well recognized course of dealing. This course of dealing would become a part of any contract, agreement or arrangement made between the bank and the broker, without any specific reference being made thereto.

The record discloses that in every instance (it is true that they were probably very few in number) where the broker was unable to repay the "day" or "clearance" loan, the specific securities, of which the broker obtained possession by the use of said "day" loan, were lodged with the bank or a trust receipt given therefor evidencing the fact that such securities were retained by the broker for the bank's sole benefit.

III.

Rights of Bank.

The written agreement of November 8, 1901, between the Bank and J. M. Fiske & Co. provided among other things as follows:

"That the undersigned, [J. M. Fiske & Co.]
* * * hereby agree with the said Bank

that whenever the undersigned shall become or remain, directly or contingently, indebted to the said Bank for money lent, or for money paid for the use or account of the undersigned, or for any overdraft or upon any endorsement, draft, guarantee or in any other matter whatsoever, or upon any other claim, the said Bank shall then and thereafter have the following rights, *in addition to those created by the circumstances from which such indebtedness may arise against the undersigned* * * * namely:

1. All securities deposited by the undersigned with said Bank, as collateral to any such loan or indebtedness of the undersigned to said Bank shall also be held by said Bank as security for any other liability of the undersigned to said Bank, whether then existing or thereafter contracted; and said Bank shall also have a lien upon any balance of the deposit account of the undersigned with said Bank existing from time to time, and upon all property of the undersigned of every description left with said Bank for safe keeping or otherwise, or coming to the hands of said Bank in any way, as security for any liability of the undersigned to said Bank now existing or hereafter contracted.

2. Said Bank shall at all times have the right to require from the undersigned that there shall be *lodged* with said Bank as security for all existing liabilities of the undersigned to said Bank, approved collateral securities to an amount satisfactory to said Bank; * * *" (pp. 452-3). (Italics ours.)

It is noteworthy that the provision giving the bank certain enumerated rights "in addition to those created by the circumstances from which such indebtedness may arise against the undersigned" is also found, practically verbatim, in the form of agreement used by The First National Bank of the City of New York (p. 263) and in the note of The Hanover National Bank of the

City of New York (p. 441). In the form used by the National Bank of Commerce in the City of New York it is expressly stipulated that the securities obtained by the use of the funds loaned thereunder shall be held in trust for the bank and subject to its lien for the moneys so advanced (p. 444).

Under this agreement and the general custom proven as to the "day" or "clearance" loan, the bank in the first instance acquired a lien upon or right in or to the money constituting the "day" or "clearance" loan which on January 19, 1911, amounted to $400,000.

When the credit of $400,000 was passed to the account of J. M. Fiske & Co. on the morning of that day the bank at that instant acquired the right to demand that it be made good not later than at the close of the business day. It also became entitled to demand that each and every part of said credit was to be used by the brokers only for the clearance of securities, and before any of said credit was so used, the bank had a lien upon or right to appropriate for the payment and cancellation of said "day" or "clearance" loan said sum so credited to the broker's account.

When said sum was used for the clearance of securities, the bank in no way released or lost its lien upon or right in or to said money. There was simply a substitution of property of some kind which took the place of some portion of the "day" or "clearance" loan.

In order that the appellant maintain this lien or right, it must be able to trace said sum so advanced and identify the securities or the proceeds of securities in the possession of the brokers, as coming into their hands by the use of or in the place of said original credit or some part thereof.

From Appendix A hereof it appears that of the securities received by Mr. Roe, all with the single exception of ten shares of Interboro-Metro-

politan Company common stock, had come into the possession of J. M. Fiske & Co., by the direct use of the said $400,000 advanced as the "day" or "clearance" loan on January 19, 1911. The bank's lien upon or right in and to said securities so traced was as absolute as though the original $400,000 still remained to the credit of the broker.

IV.

Authorities.

(*a*) *The contract must be construed in the light of the law of New York.*

The contract was made to be performed in the financial district in the City of New York. It must, therefore, be read in the light of the law of New York.

Richardson v. *Shaw*, 209 U. S., 365.
Hiscock v. *Varick Bank of New York*, 206 U. S., 28.
Humphrey v. *Tatman*, 198 U. S., 91.
Thompson v. *Fairbanks*, 196 U. S., 516.
Skiff v. *Stoddard*, 63 Conn., 198.

(*b*) *The contract is not void as against creditors in New York State.*

The only contracts which are void against creditors in New York State are contracts which are:

(1) in fraud of creditors—

Security Warehousing Co. v. *Hand*, 206 U. S., 415.
Zartman v. *First Nat'l B'k*, 189 N. Y., 267.

(2) void under the statute—

Skilton v. *Codington*, 185 N. Y., 80.

(*c*) *Custom.*

Every business is necessarily governed by the general usages which are recognized among those engaged in it.

"A general custom is the common law itself, or a part of it." And written contracts, by implication, incorporate custom into them.

> *Underwood* vs. *Greenwich Ins Co.*, 161 N. Y., 413, 423-424.
>
> *Newhall* vs. *Appleton*, 114 N. Y., 140.
>
> *Walls* vs. *Bailey*, 49 N. Y., 464, 467-471.
>
> *Botany Worsted Works* v. *Wendt*, 22 Misc. (N. Y.), 156.
>
> *Hostetter* v. *Park*, 137 U. S., 30, 40.

Persons engaged in a particular trade or business are bound to inform themselves as to the customs and usages of such business, hence knowledge on their part will be presumed.

> "If a person of a particular occupation in a certain place makes an agreement by virtue of which something is to be done in that place, and this is uniformly done in a certain way by persons of the same occupation in the same place, it is but reasonable to assume that the parties contracting about it, and specifying no manner of doing it different from the ordinary one, meant that the ordinary one and no other should be followed. Parties who contract on a subject matter concerning which known usages prevail, by implication incorporate them into their agreements, if nothing is said to the contrary."
>
> Per DAVIS, *Justice*, in *Robinson* v. *U. S.*, 13 Wall. (U. S.), 363, 366.

See also

Hazard's Admr's v. *New England Marine Ins. Co.*, 8 Pet. (U. S.), 557.
Hartshorne v. *Union Mutual Insurance Co.*, 36 N. Y., 172.

J. M. Fiske testified that he had been a member of the firm of J. M. Fiske & Co. for "sixteen or seventeen years" (p. 53). This was ample time to fasten on him and his firm a thorough knowledge of the customs of the financial district.

The defense here is based on the *entire* agreement not on any part of it, and the situation of the parties is the same as though the suit had been brought by the original contractors, for their trustees in bankruptcy merely stand in their shoes, and are subject to all defenses to which the original contractors would have been subject.

It follows from the authorities that the proof of custom was competent.

See, also,

Megowan v. *Peterson*, 173 N. Y., 1, 5 and 6, and cases cited.
Nightingale v. *J. H. & C. K. Engle, Inc.*, 141 App. Div. (N. Y.), 386, 389.

Furthermore the existence of the custom was sufficiently proved as a matter of *fact*. Messrs. Roe, Carse and Alexander all testified as to how these advances were made, and the stipulation expressly provides that if officers of other banks doing a similar business as members of stock exchange houses who obtained similar advances were called, they would have testified to the same effect as Messrs. Carse and Alexander (pp. 262, 266).

In spite of the conclusion reached by the learned District Judge to the effect that the bank by its contract deliberately predicated its lien on possession, it is significant that the word "delivered" is not used in the written agreement of

November 8, 1901. If the contract had involved a question of the bank's right to demand *delivery*, which term might be construed in the case of personal property, which was the medium they were dealing with, to involve the notion of passing title, surely the contract would have used the word. The use of the word "lodged," however, does not carry with it the same legal significance as does the word "delivered," and the use of the former word clearly recognizes the custom, the fact that the bank's title and right to demand actual possession was secured, and that the brokers' possession was possession for the moment and that was all.

As expressed by the testimony of Mr. Carse the brokers had possession of the securities "in transit" (p. 219). This being so it is apparent that the contract of November 8, 1901, when accompanied with a request for an advance, such as was delivered on the morning of January 19, 1910, did not state the entire agreement, and it has always been competent for a party sued by his promisee to show by parol evidence that the design and object of a written instrument are different from that which its language, if alone considered, would indicate.

Juilliard v. *Chaffee*, 92 N. Y., 529, 535, and cases cited.

The rule is there laid down by DANFORTH, *J.*, as follows, pages 535 and 536:

> "The apparent obligation incurred by the defendant under the paper put in evidence by the plaintiff, was to pay the sum named upon demand in consideration of so much money then borrowed; but the evidence disclosed that it was only part of a prior parol agreement, by the terms of which the payees were to advance money in anticipation upon debts owing by them, and on the defendant's promise that it should be so paid in discharge of those debts, and which also provided for a return of the paper to the defendant when the money was so applied. The note did not

> constitute the agreement, nor is it set out in the complaint as the foundation of the action. It is evidence of part of the agreement, and when relied upon by one party, the other might properly show in defense, the whole transaction."

See also

Grierson v. *Mason*, 60 N. Y., 394.

The written contract provides that the bank shall have certain rights therein defined "*in addition to those created by the circumstances from which such indebtedness may arise*" (*p. 452*). Broadly speaking, the written agreement deals solely with property in possession. It makes no specific reference to any rights it may have to property out of possession and yet it refers to certain rights "created by the circumstances from which such indebtedness may arise." Manifestly the proof of the custom may be shown under this direct reference to other rights in addition to those specifically quoted.

The evidence is entirely within the rule laid down by Mr. Justice Nelson in *Oelricks* v. *Ford*, 23 How. (U. S.), 49, at p. 63:

> "This proof is admissable in the absence of express stipulations, or where the meaning of the parties is uncertain upon the language used, and where the usage of the trade to which the contract relates, or with reference to which it was made, may afford explanation, and supply deficiencies in the instrument. Technical, local, or doubtful words may be thus explained. *So where stipulations in the contract refer to matters outside of the instrument, parol proof of extraneous facts may be necessary to interpret their meaning.* [Italics ours.]

(d) *Equitable Lien.*

The doctrine of "equitable liens" is now thoroughly established. We have been unable to find any better statement of the nature of the right or

of its origin than that contained in Pomeroy on Equity Jurisprudence:

> "The doctrine may be stated in its most general form that every express executory agreement in writing, whereby the contracting party sufficiently indicates an intention to make some particular property, real or personal, *or fund, therein described or identified*, a security for a debt or other obligation, or whereby the party promises to convey or assign or transfer the property as security, creates an equitable lien upon the property so indicated, which is enforceable against the property in the hands, not only of the original contractor, but of his heirs, administrators, executors, voluntary assignees and purchasers or encumbrancers with notice. * * * The doctrine itself is clearly an application of the maxim, equity regards as done that which ought to be done." [Italics ours.]
>
> *Pom. Eq. Jur.*, 3rd Ed., Sec. 1235.

This definition has been adopted as law verbatim by this Court in the opinion of the learned Chief Justice in

> *Walker* v. *Brown*, 165 U. S., 654, 664-5.

And by the lower Federal Courts in

> *Goodnough Mercantile & Stock Co.* v. *Galloway*, 156 Fed., 504, 510.
>
> *Howard* v. *Delgado & Co.*, 121 Fed., 26, 30.
>
> *Chattanooga Nat'l Bank* v. *Rome Iron Co.*, 102 Fed., 755, 758.

The origin of the doctrine is explained by the same commentator:

> "When equity has jurisdiction to enforce rights and obligations growing out of an executory contract, this equitable theory of remedies cannot be carried out, unless the

notion is admitted that the contract creates some right or interest in or over specific property, which the decree of the court can lay hold of, and by means of which the equitable relief can be made efficient. The doctrine of 'equitable liens' supplies this necessary element; and it was introduced for the sole purpose of furnishing a ground for the specific remedies which equity confers, operating upon particular identified property, instead of the general pecuniary recoveries granted by courts of law. It follows, therefore, that in a large class of executory contracts, express and implied, which the law regards as creating no property right nor interest analogous to property, but only a mere personal right and obligation, equity recognizes *in addition to the personal obligation*, a peculiar right over the thing concerning which the contract deals, which it calls a 'lien,' and which, though not property, is analogous to property and by means of which the plaintiff is enabled to follow the identical thing, and to enforce the defendant's obligation by a remedy which operates directly upon that thing. The theory of equitable liens has its ultimate foundation, therefore, in contracts, express or implied, which either deal with or in some manner relate to specific property, such as a tract of land, particular chatels or securities, *a certain fund*, and the like."

Applying the doctrine, the Chief Justice, then Mr. Justice White, in *Walker* v. *Brown, supra*, laid down the general rule that every express executory agreement, whereby the contracting party sufficiently indicates an intention to make some particular property therein described or identified, a security for a debt or other obligation creates an equitable lien on the property in question.

See also

Ingersoll v. *Coram*, 211 U. S., 335, 368.

The reasoning of this excerpt was also adopted by Judge Bradley in *Hovey* vs. *Elliott*, 118 N. Y., 124.

Perhaps the leading case upon this subject is *Holroyd* vs. *Marshall*, 10 H. L. C., 191. There the learned Lord Chancellor Westbury formulates the following definition:

> "In Equity it is not necessary for the alienation of property that there should be a formal deed of conveyance. A contract for valuable consideration, by which it is agreed to make a present transfer of property, passes at once the beneficial interest, provided the contract is one of which a Court of Equity will decree specific performance.
>
> "* * * And this is true, not only of contracts relating to real estate, but also of contracts relating to personal property, provided that the latter are such as a Court of Equity would direct to be specifically performed."

A party may then by express agreement create a charge or claim in the nature of a lien on property of which he is the owner or possessor, and equity will establish and enforce such charge or claim not only against the party who stipulated to give it, but also against third persons, who are either volunteers, or who take the estate on which the lien is agreed to be given, with notice of the stipulations.

Ketchum v. *St. Louis*, 101 U. S., 306.
Hauslet v. *Harrison*, 105 U. S., 401.
Carr v. *Hamilton*, 129 U. S., 252.
Fourth Street Natl. Bk. v. *Yardley*, 165 U. S., 634.
Walker v. *Brown*, 165 U. S., 654.
Ingersoll v. *Coram*, 211 U. S., 335.
Hurley v. *Atchison, Topeka & Santa Fe Ry. Co.*, 213 U. S., 126.
Sexton v. *Kessler*, 225 U. S., 90.

Dressel v. *North State Lumber Co.*, 119 Fed., 531.
First National Bank v. *Penn. Trust Co.*, 124 Fed., 968.
Fisher v. *Zollinger*, 149 Fed., 54.
Union Trust Co. v. *Bulkeley*, 150 Fed., 510.
Mills v. *Virginia-Carolina Lumber Co.*, 164 Fed., 168.
In re Farmers Supply Co., 170 Fed., 502.
Goodnough M. & S. Co. v. *Galloway*, 171 Fed., 940.
In re National Cash Register Co., 174 Fed., 579.

If such a contract is shown to exist payments made in pursuance thereof will not be invalidated as preferences by the operation of the Bankruptcy Act.

Humphrey v. *Tatman*, 198 U. S., 91.
Thompson v. *Fairbanks*, 196 U. S., 516.
In re Perlhefter, 177 Fed., 299, 303.

The agreement creating the lien may be either verbal or in writing.

Riddle v. *Hudgins*, 58 Fed., 490.

In the case at bar the learned Circuit Judge concedes that such a doctrine is well established (p. 517) and that the real question is as to whether under the facts as shown an equitable lien does in fact exist.

The doctrine has been uniformly declared and adopted by the New York courts, and lately approved by this court (*Sexton* vs. *Kessler*, *supra*),

and is enforced as against all subsequent claimants except purchasers for value, without notice.

National Bank of Deposit v. *Rogers*, 166 N. Y., 380.
Hamilton Trust Co. v. *Clemes*, 163 N. Y., 423.
Am. Sugar Rfg. Co. v. *Fancher*, 145 N. Y., 552.
Hovey v. *Elliott*, 118 N. Y., 124.
Coats v. *Donnell*, 94 N. Y., 168.
Spring v. *Short*, 90 N. Y., 538.
Husted v. *Ingraham*, 75 N. Y., 251.
Payne v. *Wilton*, 74 N. Y., 348.
McCaffrey v. *Woodin*, 65 N. Y., 459.
Parshall v. *Eggert*, 54 N. Y., 18.
The Bank of Rochester v. *Jones*, 4 N. Y., 497.

In the case of *Hurley* v. *Atchison, Topeka & Santa Fe Ry. Co.*, 213 U. S., 126, the defendant entered into an agreement with a coal company to supply it with coal. Each month it paid for the coal furnished during the preceding month. The coal company became financially involved, and in order to lend it aid the defendant made advances which were to be credited on account of coal to be mined and delivered in the future. The coal company became bankrupt owing the railway some $57,000 for moneys thus advanced. The railroad applied in the bankruptcy proceedings to compel the receivers to mine and deliver the coal. The District Court denied the relief on the ground that to grant it would constitute an unlawful preference under the Bankruptcy Act. This ruling was reversed by the Circuit Court of Appeals, which in turn was affirmed by this Court, which thus recognized the equitable right of the claimant in the absence of both a lien and an agreement for a lien, merely because the understanding

of the parties was that that the coal should be delivered, and it would be inequitable not to give the railroad the benefit of the understanding.

Speaking of this agreement Mr. Justice BREWER said (p. 132):

> "*To ignore this element* and make the bankruptcy proceedings operate to discharge this obligation of the coal company, and leave the transaction as one of an independent loan of money to the coal company *would result in destroying the full equitable obligations of the coal company*, and placing the parties in their relations to each other on an entirely different basis from what had been contemplated by them when they entered into this original agreement. While decisions directly in point may not be found, yet see *Ketchum* v. *St. Louis*, 101 U. S., 306-317; *Hauslet* v. *Harrison*, 105 U. S., 401; *Carr* v. *Hamilton*, 129 U. S., 252; *Fourth Street Bank* v. *Yardley*, 165 U. S., 634." [Italics ours.]

The facts in this case reveal that the element of the existence of a contract which equity will enforce which seems essential both under Pomeroy's and Lord Westbury's definitions is lacking. This is overcome, by holding that the bankruptcy courts could recognize and enforce the equitable principle even if an ordinary court of equity could not. On this point Mr. Justice Brewer quotes with approval from the opinion of Circuit Judge PUTNAM in the Circuit Court of Appeals in *In re Chase* (124 Fed., 753, 755).

> "It is settled that a trustee in bankruptcy has no equities greater than those of the bankrupt, and that he will be ordered to do full justice, even in some cases where the circumstances would give rise to no legal right, and, perhaps, not even to a right which could be enforced in a court of equity as against an ordinary litigant."

The learned District Judge recognizes the extension of the doctrines of equity to aid a claimant in bankruptcy as announced in the *Hurley* case, and differentiates the case at bar from that case by finding that in that case the railroad had "the right to demand from the seller a certain amount of coal in its possession which, though not yet set apart from the bulk, was still definable in quantity. That was a specific interest in a *res* which survived bankruptcy" (pp. 344-5).

In *Goodnough M. & S. Co.* v. *Galloway*, 171 Fed., 940, an action was brought to establish a lien upon certain timber contracts assigned to the complainant. Judge WOLVERTON writing the opinion in the District Court of the District of Oregon states at page 949:

> "The agreement that the Goodnough Mercantile & Stock Company should have security—that is, a present security upon the property—constituted an equitable lien, which attended the property, the timber in the tree, the logs cut therefrom, and the lumber manufactured from such logs, and was effective against all others, save such as might have purchased for value, without notice or knowledge of the existing contractual relations between BUCK and the complainant. 'Equity looks upon things agreed to be done as actually performed.' Buck having agreed that the complainant should be secured for the advances upon certain and definitely specified property, equity will, for the purpose of making the contract effective, deem that the security was actually given, and so treat the transaction. By virtue of the agreement therefore the complainant acquired an equitable lien upon the property designated, and that lien attends the fund in the hands of the trustee in bankruptcy. * * * See *Hauslet against Harrison*, 105 U. S., 401, and the decision rendered in the case at bar on the demurrer to the bill, 156 Fed. 504."

In *Hauslet* vs. *Harrison*, 105 U. S., 401, one Bayer entered into a contract with Hauslet whereby in consideration of moneys advanced by the latter for the purchase of skins he agreed that he would tan, finish and deliver them to Hauslet. Hauslet in consideration of a commission on sales and a further percentage to cover insurance, storage and labor agreed to sell them and put the proceeds less commissions, etc., at the disposal of Bayer. It was further agreed that all skins, whether green, in the process of tanning, or tanned and finished, should be considered as security for refunding the moneys advanced. Bayer became financially embarrassed and unable to proceed with his business, a fact of which Hauslet was aware. In order to carry out the first contract they then entered into another contract whereby Hauslet was to take possession of Bayer's tannery, and run and use it with such materials as would be necessary to finish and sell the skins, the net proceeds to be put to the credit of Bayer after deducting expenses and advances. Bayer four days thereafter filed his petition in bankruptcy. Hauslet took possession of the skins, and Bayer's assignee in bankruptcy brought an action to replevy them.

Held, Replevin did not lie. Bayer had not an unqualified property in the skins. They were subject to a charge in the nature of a mortgage in favor of Hauslet, which was binding upon the parties and upon Bayer's assignee.

Per MATTHEWS, *Justice* (pp. 405-7):

> "We cannot agree with the Circuit Court in the construction, that the only security given to Hauslet by the contract was the personal promise of Bayer that he would perform it. To limit the contract to that extent is to deprive its last provision of all force; for, without it, the personal obligation to deliver the skins when tanned would still remain. *The clause providing for security*

must be held to mean something; and it declares that the skins themselves, before delivery of possession to Hauslet under the contract, for purposes of sale, shall be considered as security.

It was decided in *Gregory* v. *Morris* (96 U. S., 619) that the legal effect of such a contract is to create a charge upon the property, not in the nature of a pledge, but of a mortgage. *Such a lien is good between the parties, without a change of possession,* even though void as against subsequent purchasers in good faith without notice, and creditors levying executions or attachments; *and if followed by delivery of possession, before the rights of third persons have intervened, it is good absolutely.*

Nor can it be reasonably doubted that this equitable lien was capable of enforcement. If Bayer had, in disregard and violation of his agreement, undertaken to divert the skins, whether in a finished or unfinished state, to some other and unauthorized use, it would have been in fraud of the rights of Hauslet, and a court of equity would not have hesitated by an injunction to prevent the commission or continuance of the wrong. Bayer would, under such circumstances, be treated by a court of equity as a trustee, fraudulently dealing with and misappropriating trust property, and Hauslet would be protected in his rights, as owner of a beneficial interest in the property, entitled to the enjoyment of the specific points of the agreement.

* * * * *

* * * The transaction of Nov. 6, 1874, though made with knowledge of Bayer's insolvency, and in contemplation of his bankruptcy, if made in good faith, as it is admitted to have been, for the purpose of securing to Hauslet the benefits of the contract of May 29, 1874, was legitimate, and did not constitute, as was held by the Circuit Court, an unlawful preference in fraud of the bankrupt law." [Italics ours.]

In *Dressel* v. *North State Lumber Co.*, 119 Fed., 531, the facts showed that by an express agreement between the president of the defendant, a bankrupt corporation and the First National Bank of Durham, a check for $3,500 was drawn by North State Lumber Co., Limited, by John R. Cochran, President, to the order of John R. Cochran, and endorsed "John R. Cochran, North State Lumber Co., by John R. Cochran, President, Manufacturers' National Bank of Baltimore, Murchison National Bank of Wilmington, and the Fidelity Bank of Durham". This check was presented for payment on October 30th and paid on October 31. The check was given for a specific purpose and was to be placed in the Manufacturers' National Bank of Baltimore to the credit of the North State Lumber Co. subject to the check of J. S. Manning, attorney for the North State Lumber Co. The deposit was made as the basis of a loan they were to make through the bank of deposit. The loan was not made and the funds were withdrawn by the check of J. S. Manning, attorney and placed to the credit of the North State Lumber Co. in the First National bank of Durham to pay the original check of $3,500 drawn on that bank. *Held*, no preference was shown to have been given.

In *Mills* v. *Virginia Carolina Lumber Co.*, 164 Fed., 168, one Franklin was a manufacturer of lumber. On January 4, 1905, he borrowed from the Virginia Carolina Lumber Co. $750 and delivered two notes for $375 each payable at 4 and 6 months. As security therefor Franklin executed to one Sackett, as trustee, a deed of trust covering certain of his property. Subsequently the lumber company and Franklin entered into a contract, by which the lumber company agreed to purchase the entire output of Franklin's planing mill at certain scheduled prices, the lumber to be delivered F. O. B.

at the mill. The terms of payment were that the company was to pay 80% on each shipment upon receipt of invoice and bill of lading, and 20%, less discount, on receipt and acceptance of the lumber. During the month following the making of the contract the lumber company advanced to Franklin various sums of money, aggregating $950 on open account under the contract. The lumber company held no security for their advances. In March, 1905, Franklin filed a voluntary petition in bankruptcy and was duly adjudged a bankrupt. A few days prior to the filing of the petition certain officers of the lumber company had discussed with Franklin his financial affairs and he had told them he was insolvent. The lumber company thereupon demanded of Franklin the delivery of about $1,000 worth of lumber which had been manufactured and was at the mill. After some hesitation Franklin delivered the same. Subsequently the lumber company proved its $750 debt in bankruptcy filing with it the deed of trust which had been given as security therefor. The proof of claim was objected to by the Trustee in bankruptcy on the ground that the lumber company had received $1,000 worth of lumber just prior to the filing of the petition, and that in so doing it had received a preference.

The District Court held that by taking the lumber under the circumstances shown the lumber company had not obtained a preference under the Bankruptcy Act which would defeat its right to prove the claim of $750 for money loaned.

The Circuit Court of Appeals for the Fourth Circuit affirmed the order of the District Court.

District Judge Boyd, writing for the Circuit Court of Appeals, used the following language (pp. 170-171):

> "There was no suggestion that the contract made between the lumber company and Franklin for the purchase of the entire out-

put of Franklin's mill was not a fair one, and one that the law would enforce. The contract was still existing at the time of the adjudication, and whatever lumber was on hand as the product of the mill the lumber company had a right to claim, provided it had complied with the terms which had been agreed upon. If there had been no payment upon the contract of purchase in advance, the lumber company would have been entitled to require the trustee to surrender to it the lumber produced at the mill, provided it complied with the terms of purchase. Having advanced money upon the contract of purchase, the lumber company thereby became entitled to at least as much of the produce of the mill as it had paid for, and it could have recovered so much from the trustee even after the bankruptcy. It is our opinion that, at most, the taking of the $1,000 worth of lumber under a claim by the lumber company that it was entitled to the specific property by virtue of the contract of purchase cannot be construed into a payment upon an existing debt, such as to constitute a preference under the bankruptcy law."

Thus the Courts have come to extend the doctrine far beyond the point of resting upon the designation of any specific securities or fund which would seem to be an essential to the right of enforcement, and recognizing the equities created by the parties themselves in the course of their business transactions will enforce the same in accordance with the intention of the parties. As was said by Mr. Justice Brewer in *Hurley* vs. *Atchison, Topeka and Santa Fe Ry. Co., supra*, the doctrine now has come to stand on the foundation that "Equity looks at the substance and not at the form" of the transaction under examination (213 U. S., 126, 134).

V.

Sexton v. Kessler governs.

This case (225 U. S., 90, reported below, 175 Fed., 535) is controlling, and the case at bar is not distinguishable. Kessler & Co. made a practice of drawing bills of exchange upon their English correspondents. To secure the acceptance of these bills Kessler & Co. set aside, but retained in their own possession, certain securities, a list of which they furnished to the drawees. Under this arrangement Kessler & Co. were entitled to substitute other securities for those which they had set aside. When this was done they duly notified the English house. Kessler & Co. became insolvent, and within the four months' period delivered the securities to a representative of their English correspondents, to whom they were in debt. Suit was brought by the trustee in bankruptcy to set aside this delivery. HELD, that the transactions did not constitute an unlawful preference.

Mr. Justice HOLMES, in the opinion in this Court, says (pp. 97-99):

> "The bankruptcy law by itself does not avoid the transaction. *Thompson* v. *Fairbanks*, 196 U. S., 516. *Humphrey* v. *Tatman*, 198 U. S., 91, 95. A trustee in bankruptcy does not stand like an attaching creditor; he gets no lien by the mere fact of his appointment. *York Manufacturing Co.* v. *Cassell*, 201 U. S., 344; *Zartman* v. *First National Bank of Waterloo*, 216 U. S., 134, 138. The most obvious objection is that the continued physical power of the New York firm over the securities and its right to withdraw and substitute admittedly reserved are inconsistent with a title or lien of the English house in any form. But the decisions of this court and of New York agree that there may be title in a stronger case than this. * * *

* * * So a general promise to give security in the future is not enough. But the present was a more limited and cautious dealing. It was confined to specific identified stocks and bonds on hand, and purported to give an absolute present right, qualified only by possible substitution and perhaps by a right of partial withdrawal if the remaining securities had arisen sufficiently in value. It purported not to promise but to transfer; and the subject matter was not goods and chattels in the sense of the New York mortgage law as we understand that law to be interpreted by the New York courts. The transaction was not void as against creditors irrespective of attachment as in *Knapp* v. *Milwaukee Trust Co.*, 216 U. S., 545; *Niles* v. *Mathusa*, 162 N. Y., 546. There can be no doubt, as was said by the court below, that before the bankruptcy the English house had an equitable right at least to possession if it wanted it. While the phrase equitable lien may not carry the reasoning further or do much more than express the opinion of the court that the facts give a priority to the party said to have it, we are of opinion that the agreement created such a lien at least, or in other words, that there is no rule of local or general law that takes from the transaction the effect it was intended to produce. *Hurley* v. *Atchison, Topeka & Santa Fe Ry. Co.*, 213 U. S., 126, 134. When the English firm took the securities it only exercised a right that had been created long before the bankruptcy and in good faith. Such we understand to be the law of New York and in the absence of any controlling statute to the contrary such we understand to be what the law should be. *Parshall* v. *Eggert*, 54 N. Y., 18; *National Bank of Deposit* v. *Rogers*, 166 N. Y., 380."

From this opinion, the opinions below and especially the opinion in the case of *Hurley* v. *Atchison, Topeka & Santa Fe Ry. Co.* (*supra*), it is ap-

parent that a bankruptcy court sitting as a court of equity seeks to carry out the intention of the parties without regard to the form or the transaction.

Mr. Justice BREWER, in the opinion in the *Hurley Case* (at p. 134) approves the following statement of the rule made by Circuit Judge Adams in writing the opinion in the Circuit Court of Appeals:

> "If the parties intended the arrangement to be one for borrowing and securing the repayment of money, we ought, as between them, to so regard it and treat it as creating an equitable charge or lien however inartificially it may have been expressed."

We respectfully submit that the record shows there can be no doubt that the appellant intended to have the proceeds of the "day" or "clearance" loan used for a particular purpose and to get and have security for such "day" or "clearance" loan, and J. M. Fiske & Co. intended to make use of the credit for the particular purpose and to give security therefor.

Apparently the only distinction between the *Kessler* case and the case at bar is one of form and not of substance, in that in the *Kessler* case certain securities were put in an envelope and a list of the enclosed securities noted on the outside of the envelope. The securities were not taken from the possession of the bankrupt and the bankrupt had at all times the right of substitution and could abstract any of the enclosed securities and substitute others and simply erase the name of the abstracted security and add the name of the substituted security. This same thing could have been done by Fiske & Company had it been necessary or desirable. The bank had a right to take possession of all securities of which the broker obtained possession by

use of the proceeds of the "day" loan, and such securities could at all times be identified and were sufficiently identified to enable the bank to determine upon what it had a lien or to what it had a right.

Suppose a check of $20,000 had been certified and paid to enable J. M. Fiske & Co. to obtain possession of 250 shares of stock. If J. M. Fiske & Co. had placed the certificate for said shares in an envelope and endorsed thereon the name of the bank, the number and names of the shares, and this course had been followed in each instance when a check had been certified and paid and stock received in place thereof, there would be no distinction between that transaction and the transaction in the *Kessler* case.

If when other shares of stock were substituted in the place of those first obtained a notation was made on the envelope the situation would still be on all fours with the *Kessler* case. The proceeds realized for shares were deposited in the bank in part payment of the loan or used to obtain possession of securities. If when such securities were obtained, the certificates were placed in the envelope and the name and number endorsed thereon, the *Kessler* case would still be indistinguishable.

Surely a court of equity having the clear intention on the part of the appellant and J. M. Fiske & Co. to obtain and give security will not permit such intention to be defeated because the form of placing securities in an envelope and endorsing thereon, the name and number of such security has been omitted for the sake of convenience.

VI.

The right of a broker to substitute one kind of security for another does not alter the rights of the parties.

The right to trace specific funds in resulting securities has been recognized and established by this Court beyond all argument. A case akin to that at bar is the case of *Gorman* v. *Littlefield*, 229 U. S., 19, decided at the last term of the Court.

In that case a customer of a defunct broker's house sought to obtain an order directing a trustee in bankruptcy to deliver to him certain shares of stock which it was shown that he had ordered the brokers to purchase outright for him at a time when he had sufficient credit with them to pay for the same. It was proved that in compliance with his orders the stock had been purchased, and that certain specific certificates had been delivered to the broker against the purchase. It was also shown that these certificates had in the course of the broker's business been used by him in the consummation of other contracts, but that the broker had always, and the trustee in bankruptcy on going into possession of the estate had, received sufficient stock of the kind in question to deliver certificates representing the stock so purchased.

Held. The customer was entitled to certificates representing the amount of stock purchased by him, even though the certificates may not be identical with the ones purchased and received upon the execution of his order.

The opinion of Mr. Justice DAY stands on the broad ground that under such circumstances the certificates in fact did not constitute a part of the bankrupt's estate, and that

> "No creditor could justly demand that the estate be augmented by a wrongful conversion of the property of another in this manner or the application to the general estate

of property which never rightfully belonged to the bankrupt" (25).

We submit that there is no distinction in principle between the *Gorham* case and the case at bar. The $400,000 credit was given for a particular purpose and the appellant is entitled to the avails of that credit obtained in pursuance of that purpose.

See also

Richardson v. *Shaw*, 209 U. S., 365.

SECOND POINT.—The appellee was entitled to set off the deposit of $54,048.18.

The undisputed evidence is that this deposit consisting of several checks was received some time before 12 o'clock (pp. 80-81). Prior to its receipt Mr. Roe, the cashier of the appellant bank, had been told that there were rumors about the brokers, and had been informed at the bank that no deposit under the "day" or "clearance" loan of that day had been made; Mr. Roe thereupon went to the office of the brokers and asked Mr. Sherwood, a member of the firm, why no deposit had been made, and was informed that there was a deposit on the way around to the bank (pp. 95-96).

The deposit was sent and made in the usual course of business, was a step in the repayment of the "day" or "clearance loan", was a recognition by the brokers of the rights of the appellant, and was an act which had been done precisely in the same way for years past.

This deposit came in while Mr. Roe was out on his errand to J. M. Fiske & Co.'s office. It had not been received when he left the bank (pp. 81, 110, 312, 318).

There is absolutely no proof that the financial

condition of the brokers played any moving part in prompting the making of this deposit at the time it was made, nor was there any evidence to show that it was made with any intention on the part of the brokers to prefer the bank, nor was it made at the request of the bank.

The Special Master found that prior to his departure Mr. Roe had directed the certification clerk and paying teller not to certify or pay any more checks drawn by the firm, and concluded that the deposit having been received after these instructions had been given the relation of banker and depositor was never established, and that the deposit in reality constituted a payment on account of the broker's indebtedness to the bank, and came under the ban of the statute (p. 312). The District Judge reached the same conclusion (pp. 318-9), and the Circuit Court of Appeals concurred (pp. 519-520).

In this connection we point out Mr. Roe's testimony:

> "I gave instructions not to pay any more *until they heard from me*" (p. 88).

When these instructions were given the brokers had failed to make any deposit and had apparently broken the agreement made with the Bank. Later after Mr. Roe's return from the office of J. M. Fiske & Co. he gave final instructions to the tellers "not to pay anything more" (p. 101), but when the deposit was received the only instructions the tellers had were in effect not to allow any activity in the J. M. Fiske & Co. account without consulting with the cashier. There is absolutely no proof that during this period, short as it may have been, the appellant was requested or refused to recognize the relation of banker and depositor between itself and J. M. Fiske & Co., but this does not mean that that relation was

terminated until the cashier finally returned and directed the closing of the account, which was admittedly at a time subsequent to the receipt of the deposit.

Even though the Bank had no right in equity to have all or nearly all of the proceeds of the checks composing the deposit of $54,018.18 applied in part payment of the "day" or "clearance loan". The moment the checks composing said deposit were received by the appellant and passed to the credit of the brokers the funds became the appellant's property and the relation of debtor and creditor was created.

New York County Nat'l Bank v. *Massey*, 192 U. S., 138.
National Bank v. *Burkhart*, 100 U. S., 686.
Cassidy v. *Uhlman*, 170 N. Y., 505, 515, and cases cited.

The relation of debtor and creditor having been created the right of set off was also established.

New York County Nat'l Bank v. *Massey*, 192 U. S., 138.
Joyce v. *Auten*, 179 U. S., 591.
Scott v. *Armstrong*, 146 U. S., 499.
Straus v. *T. N. Bank*, 122 N. Y., 379.

Both under the agreement Exhibit A and the authorities cited above (Point I) the appellant was entitled to have this sum applied in part repayment of the "day" or "clearance loan" and to set off this deposit.

It has been conceded throughout this case that if the broker had continued in the transaction of his day's business that the appellant would have been entitled to call him to account for his day's use of its funds lent to him for a particular purpose. It has been seen that while it may

often happen that his transactions may not be completed in their entirety before 3 o'clock, deliveries begin and contracts are continually being consummated throughout the day, and the banks are constantly urging the brokers to make their deposits (pp. 115-117; 244). In fact this is done to such effect that often the "day" loans are all cleared up by one o'clock. There is no intimation in the record that there was any apprehension as to the financial standing of J. M. Fiske & Co. at the opening of business on January 19, 1910, and they had no trouble in negotiating their "day" loan of $100,000 on that morning. The first the appellant heard of even a rumor of their difficulty was just before Mr. Roe went to that firm's offices shortly before twelve o'clock (pp. 90-91). Columbus and Hocking Coal and Iron Co. common stock opened at 10 o'clock around 88½ (p. 272) and by 11:30 had dropped to 76 (p. 164). In the next half hour the stock became very active and dropped from 76 to 60 (pp. 164-5) and in the course of the day further declined to 25 (pp. 272).

When Mr. Roe went to J. M. Fiske & Co.'s office he was told by Mr. Sherwood that a deposit was on its way to the bank (pp. 95-96). The truth of this statement was ascertained by Mr. Roe on his return to the bank, and if an analysis is made of the deposit itself it will be seen that practically all of it is the proceeds of securities delivered that morning.

Attached hereto marked Appendix B is a tabulation showing the deposit itemized as set forth in the brokers check book (Plaintiff's Exhibit 27). We have also sought to show from the brokers blotter (Plaintiff's Exhibit 23) the purpose for which the brokers received these checks.

If we eliminate the two Schott checks and the exchange charge aggregating $372.20 from the ag-

gregate of $54,420.38 as shown by the check book to have been deposited (see note to Appendix B), it will be seen that of the remaining $54,048.18 all with the exception of the F. Barrell & Co. check of $5,000 and the G. S. Kerr check of $200 was the direct result of the proceeds of the sale of securities. The sum so acquired amounts in the aggregate to $47,456.75.

While we do not in any sense concede that the appellant did not have a right to set off the entire sum of $54,048.18 by virtue of its rights as a banker to whom its depositor was indebted and while we do not concede that it did not also have a right to the entire fund under its agreement Defendant's Exhibit A we point out that if the deposit is split into two parts it had the right to take the $6,591.43 under its right to set-off and was entitled to the sum of $47,456.75 because that same was the proceeds of securities purchased with its moneys.

THIRD POINT.—The case involves no question of actual fraud.

This Court has lately pointed out with great clearness the distinction between fraudulent transfers and transfers which may be set aside as preferential under the Bankruptcy Act.

Van Iderstine v. *National Discount Co.*, 227 U. S., 575.

Coder v. *Arts*, 213 U. S., 223;

> "An attempt to prefer is not to be confounded with an intent to defraud, nor a preferential transfer with a fraudulent one"

Per Mr. Justice Day, in *Coder* v. *Arts* (*supra*), at page 241, quoting and approving *Githens* v. *Shiffler*, 112 Fed., 505.

> "The statute recognizes the difference between the intent to defraud and the intent to prefer, and also the difference between a fraudulent and a preferential conveyance. One is inherently and always vicious; the other innocent and valid, except when made in violation of the express provisions of a statute. One is *malum per se* and the other *malum prohibitum*,—and then only to the extent that it is forbidden."
>
> Per Mr. Justice Lurton, in *Van Iderstine* v. *Nat. Discount Co.*, 227 U. S., 575, 582.

The bill of complaint it is true prayed that the transfer be set as "preferential, fraudulent and void within the purview of the Act of Congress relating to Bankruptcy" (p. 12). The Special Master, however, decided that the transfer constituted a preference as defined under the Act and was "voidable" (p. 311), and his conclusion was confirmed by the District Judge (p. 350). The decree adjudged the payments to be unlawful "preferences" (p. 352), and the opinion in the Circuit Court of Appeals is based on the same hypothesis (pp. 514-5).

At most if the transaction is to be held preferential the fraud is constructive or technical,

> "consisting in the infraction of that rule of equal distribution among all creditors, which it is the policy of the law to enforce when all cannot be fully paid."
>
> Per Dodge District Judge, in *In re Maher*, 144 Fed., 503, at p. 509, quoted and approved in *Coder* vs. *Arts*, *supra*.

See also

> *Keppel* v. *Tiffin Savings Bank*, 197 U. S., 356.

It follows that in order to entitle the appellees to a decree, all the prerequisites of the Bankruptcy Act must be shown to have been proved in accordance with the rules of evidence, and in such a case fraud is not rightly impugned.

> "While certain circumstances will give rise to an impression of fraud, yet the law never presumes it. It devolves on him who alleges fraud to show the same by satisfactory proof."

Per Mr. Justice Harlan in
Jones v. *Simpson*, 116 U. S., 609, 615.

FOURTH POINT.—Appellees failed to establish by a preponderance of evidence that the appellant received a voidable preference.

I.

Basis of Decision below.

The learned Special Master after reviewing the testimony stated the rule of law to be that "If a preference is in fact given and the creditor knows, or had reasonable cause to believe that the debtor at such time is insolvent, he will be held to have reasonable cause to believe that it was intended by the debtor to give him a preference" (pp. 287-288), and found on the authority of *Alexander* v. *Redmond*, 180 Fed. Rep., 92 (which he states to be the law in the 2nd Circuit) that

> "Mr. Roe when he received the securities had reasonable cause to believe that the firm of J. M. Fiske & Company were insolvent and that the effect of the transfer of the securities to the defendant would be to enable

it to obtain a greater percentage of its debt than other creditors of the same class" (pp. 290-291).

The District Judge, passing on this phase of the case, said:

> "I do not think it necessary to add anything to the Referee's report except upon two questions: first, the need of proving that the defendant knew that the bankrupts intended a preference: * * *
> Upon the first point *Alexander* vs. *Redmond*, 180 Fed. Rep., 92, is conclusive. It is idle to say that the opinion is obiter. I tried the case below and being of different opinion decided it expressly because the element of an intent was lacking. The reversal was therefore expressly upon that point and the case settles the law in this Circuit" (p. 337).

The learned Judge writing the opinion in the Circuit Court of Appeals did not touch on this branch of the case. His omission to do so we take as a tacit affirmance of the opinions of the District Judge and Special Master.

II.

Statutory Requirements

The Bankruptcy Act, in so far as it applied to the case at bar, in force on January 19th, 1910, defined preferred creditors as follows:

> "Sec. 60. *Preferred Creditors.* (*a*) A person shall be deemed to have given a preference if, being insolvent, he has, within four months before the filing of the petition, * * * made a transfer of any of his property, and the effect * * * of the * * * transfer will be to enable any one of his creditors to obtain a greater percent-

age of his debt than any other of such creditors of the same class.

(*b*) If a bankrupt shall have given a preference, and the person receiving it, or to be benefited thereby, or his agent acting therein, shall have had reasonable cause to believe that it was intended thereby to give a preference, it shall be voidable by the trustee, and he may recover the property or its value from such person" (32 U. S. Stat. at Large (1903), pp. 799-800, Act July 1, 1898, as amended).

In the same Act it is provided:

Sec. 1 (15). "A person shall be deemed insolvent within the provisions of this act whenever the aggregate of his property, exclusive of any property which he may have conveyed, transferred, concealed, or removed, or permitted to be concealed or removed, with intent to defraud, hinder, or delay his creditors, shall not, at a fair valuation, be sufficient in amount to pay his debts."

(U. S. Comp. Stat., 1901, p. 3419; Act July 1, 1898.)

Under these provisions, in order to establish a preferential payment which is voidable, the appellees must have proven the following elements:

(*a*) The debtor must have been insolvent within the definition of the Statute.

(*b*) The payment must have been in satisfaction of or on account of an antecedent debt.

(*c*) The payment must have been made within four months before the filing of the petition in bankruptcy.

(*d*) Insolvency must have existed at the time when the payment was made.

(*e*) The payment must have enabled the creditor receiving the same to obtain a greater percentage of its claim than any other creditor of the same class.

(*f*) The debtor making such payment must have intended to give such a preference.

(*g*) The creditor receiving such payment must have known or have had reasonable cause to believe that he was receiving a preference.

(*h*) The insolvent's estate must have been diminished as a result of the transaction.

Coder v. *Arts.*, 213 U. S., 223; aff'g 152 Fed., 949.
Hardy v. *Gray*, 144 Fed., 922.
Calhoun Co. Bank v. *Cain*, 152 Fed., 983.
Tumlin v. *Bryan*, 165 Fed., 166.
In re Neill-Pinckney-Maxwell Co., 170 Fed., 481.
Sparks v. *Marsh*, 177 Fed., 739.
Kimmerle v. *Farr*, 189 Fed., 295.
Remington on Bankruptcy, Secs. 1276 *et seq.*
Collier on Bankruptcy (9th Ed.), pp. 790-1.

The burden is on the trustee to prove by a preponderance of evidence each of these elements.

Barbour v. *Priest*, 103 U. S., 293.
Kimmerle v. *Farr*, 189 Fed., 295.
In re Leech, 171 Fed., 622.

(*a*) THE DEBTOR MUST HAVE BEEN INSOLVENT WITHIN THE MEANING OF THE STATUTE.

The word "insolvent" as construed in this act means that a person shall be deemed insolvent

"Whenever the aggregate of his property * * * shall not, at a *fair valuation*, be

sufficient in amount to pay his debts" (Bankruptcy Act, Sec. subd. 15, *supra*).

It has therefore quite a different meaning from insolvency as ordinarily understood, namely an inability to meet maturing obligations.

Piric v. *Chicago Title & Trust Co.*, 182 U. S., 438, 451.

McDonald v. *Clearwater Short Line Ry. Co.*, 164 Fed., 1007.

Hardy v. *Gray*, 144 Fed., 922.

Remington on Bankruptcy, Sec. 1343, pp. 786, 787.

Collier on Bankruptcy (9th Ed.), pp. 8 and 9.

As pointed out by Judge Putnam, writing the opinion of the Circuit Court of Appeals for the First Circuit in *Hardy* vs. *Gray*, *supra*, the insertion in the statute of the definition of insolvency quoted above

> "Has established so artificial a rule that the usual indicia by virtue of which a man is regarded as insolvent, and, consequently, by virtue of which a creditor may be said to have reason to believe that he is insolvent, or the reverse, became, to a very large extent, of no importance. This fact was illustrated by In re Petingill & Co. (D. C.), 135 Fed., 218, a case which came before us incidentally under the same title in (C. C. A.), 137 Fed., 840. There, marked and numerous indications of insolvency in the natural business sense of the word existed, but it was justly said that 'grounds for reasonable belief in a present inability to pay debts in the course of business are not necessarily grounds for believing that a man's property at a fair valuation is not sufficient to pay his debts' " (p. 924).

It may then well be, as was said in *McDonald* vs. *Clearwater Railway Co.* (*supra*), that

> "the aggregate of the property of the debtor, *taken at a fair valuation*, may be far in excess of the amount of his debts, and still he may not have the current funds with which to meet his indebtedness as it falls due" (p. 1014). [Italics ours.]

That such a condition of affairs does not constitute insolvency under the statute has been clearly recognized by this Court.

In *Piric* vs. *Chicago Title and Trust Co.* (*supra*), Mr. Justice McKenna discusses this requirement of the statute:

> "Inability to pay debts in the ordinary course of business usually accompanies an insufficiency of assets. It may not, of course. At times a debtor's property, though amply sufficient in value to discharge all his obligations, may not be convertible without sacrifice into that form by which payments may be made. *The law regards that possibility.* In this there is indulgence to the debtor, and through him to preferred creditors. But the discussion need not be extended. *The law has made its definition of insolvency, whatever the effect may be, and has determined by that definition consequences not only to the debtor but to his creditors and to purchasers of his property*" (p. 451). [Italics ours.]

Applying these principles the Circuit Court of Appeals for the Sixth Circuit, in *In re Klein*, 197 Fed., 241, laid down the rule that the valuation for the test of insolvency must relate to the conditions of the alleged bankrupt *as a going concern* and not at the value of its property, as a dead property after the intervention of bankruptcy.

See also

J. W. Butler Paper Co. v. *Goembel* (C. C. A., 7th Circuit), 143 Fed., 295.

The situation in regard to the financial affairs of J. M. Fiske & Co. as they developed in the course of the business day of January 19, 1910, as shown by the record, is but an example of the startling possibilities of the improper manipulation of securities as it may be practiced to-day.

There is no question that the firm was solvent from every point of view at the opening of business on that day, and yet in the course of two hours the market valuation of their securities had shrunk to such an extent that at 12 o'clock noon their balance sheet showed an excess of liabilities over assets at that moment, *i. e.*, that they were insolvent in the popular sense of that word. According to the figures of the expert accountant, Mr. Morse, as revised by stipulation, the assets of the firm at that moment amounted to $747,919.48 while their liabilities were $904,570.02, leaving an excess of liabilities over assets amounting to $156,650.54 (p. 171).

When they announced their inability to meet their obligations on the Stock Exchange, the brokers were carrying either for their own or for customers' accounts 9,740 shares of the common stock of the Columbus and Hocking Coal and Iron Co. (p. 172). This stock at the opening of the New York Stock Exchange at 10 o'clock on that day was quoted at 88½ and by noon dropped to 60, a depreciation in market value of 28½ points a share (p. 285). For a week prior to that time the same stock had been quoted at figures varying from 91¾ to 87¼ (p. 272).

Assuming the values of all other securities as taken by Mr. Morse and revised by stipulation to be stationary, it is a matter of simple mathematics

to ascertain that between the opening at 10 o'clock and 12 o'clock noon, the single item of Hocking stock shrunk in apparent value to the extent of $277,590 and a surplus of $120,939.46 had been converted into a liability of $156,650.54.

The learned Special Master admits the correctness of this computation and observes that the item of assets includes claims against customers assumed to be collectable, "but which are shown by the testimony to be worthless," amounting to $443,835.55 (p. 286), and he accordingly deducts these items.

While the Special Master does not give us the benefit of a direct statement as to just what accounts he deducted as worthless, the brief of the appellees before the Special Master shows this item to have been composed as follows:

A. P. Morrison Account	$34,732.69	
" " Acct. No. 9	34,292.40	
" " Privilege Account	60,083.20	
		$136,108.29
Marcus Schnitzer		14,876.84
Pool No. 2 or 4/1 Account		152,642.79
C. M. Washburn	$21,559.42	
" " " Special Account	4,422.71	
		25,982.13
John Felix		33,652.74
R. F. Little	$14,269.72	
" " " Special Account No. 1	13,973.84	
		28,243.56
G. T. Sullivan Cotton Account	$5,840.00	
" " " Grain "	25,610.50	
		31,450.50
Sarah L. Stevens		3,817.20
Martha L. Stevens		3,836.21
Harry E. Stevens		4,348.83
Charles McLean		8,874.46
Total		$443,833.55

The difficulty with this entire assumption is that it assumes an instantaneous liquidation not only of the brokers but of these accounts as well at 12

o'clock noon on January 19, 1910, irrespective of whether or not that liquidation is based on the "fair valuation" of the statute.

Furthermore the evidence does not support the conclusion that these accounts are all bad.

Mr. Morrison testified that while he had an interest in certain mines and industrial concerns and also in real estate, none of it was available on January 19, 1910 (p. 147). There is no evidence that his affairs could not have been worked out on a fair valuation.

The Pool No. 2 or 1/4 Account is included at $152,642.79. This is a manifest error. The Account itself shows a debtor balance of $259,240.79 secured by 3,300 shares of Hocking stock (Plaintiff's Exhibit 19, p. 402). Should this stock be considered to be liquidated at 60 it would realize $198,000, and the debtor balance is reduced to $61,240.79. At 88½ the same stock was worth $292,050.06, which amply secures the account.

In regard to the John Felix account while Mr. Fiske testified that at the time he was testifying (Nov. 2, 1910) he knew that in January, 1910, Mr. Felix had nothing (p. 56), yet on cross-examination he testified that when he was engaged in business he regarded the account as a live account and an asset of his firm at practically its full value (p. 610). From Mr. Wolf's testimony it would appear that this witness *after the bankruptcy of the brokers had interposed*, denied that they were his transactions and stated that if they were for his account that he could not pay them (p. 72). The matter was not pursued further by the trustees, and there is absolutely no showing that if the accounts were not for the account of Mr. Felix that the true creditor could not make them good.

In regard to the R. F. Little accounts, Mr. Fiske testified that on January 19, 1910, he considered Mr. Little worth something over a quarter of a million

of dollars and that after the failure he found he had nothing. As the witness expressed it "when Hocking broke, he did" (pp. 55, 57). On cross-examination he stated that the account had always been a satisfactory one, that Mr. Little had paid as demands had been made upon him and that on the morning of January 19, 1910, he had regarded the account as a live asset (pp. 61-2). Mr. Wolf had had a conference with Mr. Little in which the latter admitted his debt, stated that there were judgments against him and that he had been examined in supplementary proceedings (p. 72). There is no evidence as to what assets the supplementary proceedings revealed or whether he either could or did pay the judgments or cover his debtor balance with J. M. Fiske & Co.

The proof of the lack of value of the G. T. Sullivan accounts is entirely inferential. On direct examination Mr. Fiske did not think "it was good for much" (p. 58), and on cross-examination he stated that his firm did not approve of him (Mr. Sullivan) and his methods, so asked him to withdraw his account. When his account was closed it showed a debtor balance, but he was never asked to pay it. Mr. Fiske admitted that all he knew about Mr. Sullivan was hearsay gleaned from the newspapers and the fact that he had been arrested and was out on bail indicated nothing as to his financial standing (p. 64). Mr. Wolf was informed he was wholly uncollectable and let the matter drop (p. 74).

In regard to Harry L. Stevens, Mr. Fiske testified that he was an employee of the firm of J. M. Fiske & Co., and had been speculating in Hocking. Prior to the break in that stock his financial standing was good (p. 59). *Subsequent to the failure* of the firm Mr. Stevens told Mr. Fiske he had no money and could not pay (pp. 64-6). He admitted to Mr. Wolf his inability to pay and stated also

that the accounts of Martha L. Stevens and Sarah L. Stevens were really his own accounts, and that they knew nothing of them (p. 74).

Charles McLean was another speculating employee of J. M. Fiske & Co., and Mr. Fiske "considered that he would be able to pay anything he owed" them (p. 57), and regarded the account as an asset prior to January 19, 1910 (p. 62). Mr. Wolf ascertained that Mr. McLean practically admitted the debt and that he had a colorable counter-claim for salary due him. The only evidence of his financial standing was that he was a clerk employed on a salary (p. 74).

That the suspension of J. M. Fiske & Co. was due wholly to the break in Hocking stock is beyond question. The causes for the break are set forth very clearly in the record. Although no mention is made of the fact in the schedules of bankruptcy, the appellees were so thoroughly convinced that this break was due to a breach of trust by Mr. James R. Keene as Manager of two certain pools in said stock, in both of which J. M. Fiske & Co. were participants, that they instituted actions against Mr. Keene (pp. 133-4). The pooling agreements, together with the pleadings in these actions are all in evidence. (Defendant's Exhibits C, D, E, F, G, H, I, J and K, pp. 471-511.)

The Special Master in treating this asset held that according to the testimony it would not have exceeded $90,000. (p. 286). The record shows that the testimony on which this estimate was based was that of Mr. Wolf, one of the solicitors for the appellees who testified in response to his own question and over objection and exception by the solicitor for the appellant, that *in his opinion*

> "the maximum amount that can be recovered by the plaintiffs in these two suits is between $50,000. and $90,000." (p. 274.)

The complaints (Defendant's Exhibits H and J, pp. 475-486; 492-506), show the actions to be for accountings based on pooling agreements covering 20,000 shares each (pp. 480, 498). In the first of these J. M. Fiske & Co. had a participation of 4,000 and in the second 2,000 shares. On the morning of January 19, 1910, the brokers were carrying 9,740 shares for all accounts. If the theory of counsel for the appellant as contained in his question to Mr. Wolf which he declined to answer (p. 275), that the measure of recovery in these actions would be the difference in the value of the stock before and after the break, is correct it is manifest that on their subscriptions of 6,000 shares they suffered a loss of $171,000. on the drop of 28 1/2 points.

Our contention, however, is not directed so much to the Special Master's method of computation as to his right on the record to compute the value of this claim as he did. If Mr. Wolf's opinion is competent evidence, we have shown that his method of computation is wrong. If his testimony, as to its value is incompetent, then the record shows the existence of an asset in the hands of the appellees, whose value is not shown and which may or may not serve to make the bankrupts solvent. This being the state of the record, the proof of insolvency required by the statute must necessarily be held to be insufficient.

We do not claim that the figures given by Mr. Morse are incorrect in any particular. We do assert, however, that his testimony that the liabilities exceeded the assets is based entirely upon what the books of the firm showed and that he took an arbitrary hour (viz., 12 o'clock noon), which bears no relation to the facts of the case at bar, took market values existing at that moment, which must be admitted to have been the result of wanton ma-

nipulation and assumed an instantaneous and complete liquidation (p. 46).

If Mr. Morse's figures establish insolvency as defined in and called for by the statute, then a sudden and temporary depreciation in the market quotation of a stock such as took place during the celebrated Northern Pacific corner would also satisfy the requirements of the statute. Insolvent for 60 seconds and solvent for the rest of the business day could become a prevalent situation. The creditor who happened to receive any securities during the 60-second period would be required to give them up, while the creditor who received securities immediately preceding or subsequent to the 60-second interval could retain them.

Such a construction is so violative of the fundamental reason for the enactment of the Bankruptcy Act, viz., equality for all creditors of the same class, that no court should adopt it.

The appellees here sought to establish one of the elements necessary to predicate a statutory right. This cannot be done by deduction. There is no proof whatsoever that the *value* of Hocking actually depreciated in accordance with the fluctuations of the stock market on that day. To draw such a deduction from the record cannot be supported upon the showing made. It is inconceivable that the "fair valuation" of the stock followed the market vagaries of January 19, 1910.

Furthermore, the law recognizes the possibility of such an occurrence as is shown at bar, and declines to recognize it as a fair criterion in determining the "fair valuation" required by the statute.

> "So the market value of the shares of capital stock may sometimes be above and sometimes below the actual value. Such value may be greatly enhanced or depressed for speculative purposes without any change

in the actual value. But the market value of any stock which is listed at the Stock Exchange in New York, and largely dealt in from day to day for a series of months will usually furnish the best measure of valuation for all purposes. The competition of sellers and buyers, most of them careful and vigilant to take account of everything affecting value of stock in which they deal, and each mindful of his own interests, and seeking for some personal gain and advantage, will almost universally, if time sufficient be taken, furnish the true measure of the actual value of stock. * * * That standard is sometimes illusionary and untrustworthy."

Per EARL, *J.*, in

People ex. rel. The Knickerbocker Fire Insurance Co. v. *Coleman*, 107 N. Y., 541, 544.

"Fair valuation is not what the property would bring at a forced sale. The valuation used as a test must relate to the conditions existing in respect to the bankrupt's business as a going concern, at the time when the preference was given."

Collier on Bankruptcy (9th Ed.), p. 792.

Rutland County National Bank v. *Graves*, 156 Fed., 168.

J. W. Butler Paper Co. v. *Goembel*, 143 Fed., 295.

Chicago Motor Vehicle Co. v. *American Oak Leather Co.*, 141 Fed., 518.

Chicago Title and Trust Co. v. *John A. Roebling's Sons & Co.*, 107 Fed., 71.

It is indisputably the law that a reasonable period of time must be taken in ascertaining the value of securities.

Gallagher v. *Jones*, 129 U. S., 193.
In re Swift, 114 Fed., 947.

Wright v. *Bk. of Metropolis*, 110 N. Y., 237.
Gruman v. *Smith*, 81 N. Y., 25.
Baker v. *Drake*, 53 N. Y., 211; 66 N. Y., 518.

Furthermore the bankrupt firm being a partnership it must also be shown that each of the partners was also individually insolvent.

Francis v. *McNeal*, 186 Fed., 481, 484, and cases cited.
Tumlin v. *Bryan*, 165 Fed., 166.

The partnership was composed of Josiah M. Fiske, Dudley P. Humphrey, Clifford M. Washburn and Arthur C. Sherwood (p. 31). In support of their financial status *on January 19, 1910*, the schedules in bankruptcy of Arthur C. Sherwood and Josiah M. Fiske are in evidence (Plaintiff's Exhibit 30, p. 428 *et seq.*; Defendant's Exhibit A, p. 455 *et seq.*; Defendant's Exhibit A, p. 467). Mr. Sherwood testified that his liabilities on January 19, 1910, were $12,533.91 and that his schedules in bankruptcy showed all his individual assets (p. 212) and Mr. Fiske testified that his assets on January 19, 1910, were as shown in the Schedules (p. 181). Mr. Humphrey was called as a witness and after examining certain schedules which were shown him but not introduced in evidence, testified that his liabilities were $440.41 *and his assets not over $1,000* (p. 216). It was stipulated that if Mr. Washburn were called he would testify that his individual assets and liabilities on January 19, 1910, consisted of $276.20 assets and $96,438.91 liabilities (p. 267).

This proof does not properly establish the insolvency of all the parties on January 19, 1910. Mr. Humphrey by his own testimony is solvent and the schedules in bankruptcy of Messrs. Fiske and Sherwood, even supported to a certain extent by

their own testimony are not sufficient proof of their financial condition on January 19, 1910.

Tumlin v. *Bryan, supra.*

(*b*) THE PAYMENT MUST HAVE BEEN IN SATISFACTION OF OR ON ACCOUNT OF AN ANTECEDENT DEBT.

It was held in *Coder* vs. *Arts*, 152 Fed., 943 (affirmed in this Court, 213 U. S., 223) by Circuit Judge Sanborn writing the opinion of the Circuit Court of Appeals for the Eighth Circuit that

> "An insolvent debtor until the commencement of proceedings in bankruptcy still has the jus disponendi of his property. He has the right to secure and pay his debts with it, and he has the right to secure one creditor in preference to others, provided always the security or the payment is not violative of any of the acts of Congress or of any of the statutes of the state. A preference of one creditor over others by such a payment or by such security, which is free from actual and intended fraud, and from any purpose to affect other creditors injuriously, beyond the necessary effect of the security or the payment, is valid and lawful, and it cannot evidence such an intent to hinder, delay and defraud as will make it void or voidable under section 67e" (p. 947).

As was pointed out by Circuit Judge Ward writing the opinion of the Circuit Court of Appeals in the case at bar:

> "But it is not every transfer by an insolvent within the four months period that is voidable by the trustee. It must be on account of a pre-existing debt. When one gives an insolvent present value for a transfer of property or when he makes an exchange of property, there is no preference" (Record, pp. 516-517).

From the beginning of this litigation the transactions between banks and brokers such as that

under discussion have uniformly been considered as continuous, beginning at or about the opening of business and continuing until 3 o'clock in the afternoon (Special Master's Report, pp. 298-302). As was said by the learned Circuit Judge:

> "The loan and repayment the same day should be regarded as one transaction, the fact that they were not literally contemporaneous being a necessary result of the nature of the business" (p. 517).

The question in this case then is not whether or not the delivery of the securities was in payment of the credit given in the morning, but whether when the appellant gave the credit of $100,000 they contracted to have security therefor and whether the delivery of the securities sought to be set aside was in pursuance thereof.

If the giving of the credit was one transaction and carried with it no understanding as to security, the subsequent receipt of the security as another transaction was undoubtedly an effort to pay an antecedent debt and should come under the ban of the statute.

(*c*) PAYMENT WITHIN FOUR MONTHS OF THE FILING OF THE PETITION MUST BE ESTABLISHED.

There is no question but that the transfer took place within the time limited by the statute. The whole transaction occurred on the morning of January 19, 1910, and an involuntary petition in bankruptcy was filed against J. M. Fiske & Co., at 3:25 P. M. on that day. (Plaintiff's Exhibit 10, pp. 138, 394-398.)

The mere fact that the transfer was made within four months of bankruptcy may of itself be sufficient to constitute it a preference, but it is not, in the absence of the other statutory requirements sufficient to constitute it a *voidable* preference.

(*d*) INSOLVENCY MUST HAVE EXISTED AT THE TIME WHEN THE PAYMENT WAS MADE.

The appellees to sustain their right to recover must be shown to have made out as a part of their case the existence of insolvency *as defined by the statute* "at the moment the preference is obtained."

Tumlin v. *Bryan,* 165 Fed., 166, at 168.

Rutland County National Bank v. *Graves,* 156 Fed., 168.

J. W. Butler Paper Co. v *Goembel,* 143 Fed., 295.

In re Rome Planing Co., 96 Fed., 812.

> "It is essential to a preference that the debtor should have been insolvent at the time, *and unless this appears there is no act of bankruptcy.*" [Italics ours.]

Per ARCHIBALD, *D. J.,* in

Troy Wagon Works v. *Vasthinder,* 130 Fed., 232, 234.

The inhibition of the statute applies only to preferences given when the debtor is insolvent in fact, and a lien perfected before such insolvency is not affected.

In re Wittenberg Veneer & Panel Co., 108 Fed., 593; affd. sub voc. *McDonald* v. *Daskam,* 116 Fed., 276.

Mr. Roe fixed his time of arrival at the office of J. M. Fiske & Co. at something more than five or ten minutes before 12 o'clock noon on January 19th, 1910. His entire stay in the office of J. M. Fiske & Co. occupied less than five minutes, and he arrived back at the bank by noon or a very few minutes thereafter (pp. 91, 96). The notice of the inability of J. M. Fiske & Co. to meet their current obligations was received at the New York

Stock Exchange at 12:40 P. M. (p. 42). The petition in bankruptcy was filed at 3.25 P. M. (p. 138). These facts are uncontradicted, and it is therefore incumbent upon the appellees to establish the fact that J. M. Fiske & Co. and the several members of said firm, were insolvent within the meaning of the Bankruptcy Act, between ten minutes before 12 o'clock M. and 12 o'clock noon on January 19th, 1910. It is apparent that this proof does not meet the requirements of the statute in this regard.

It is a well known fact that on the Stock Exchange, quotations vary enormously in a few moments, and this is especially so in "panicky" times. Such was the case in the suit at bar, and in such a case, the law will recognize the fraction of a day and the rule that the law takes no notice of the fraction of a day is inapplicable.

Upson v. *Mount Morris Bank*, 103 App. Div. (N. Y.), 367.

The adjudication of bankruptcy on March 12, 1910, did not relate back to the filing of the petition and is not evidence of insolvency prior to such filing.

Tumlin v. *Bryan*, 165 Fed., 166.
In re Chappell, 113 Fed., 545.
In re Alexander, 102 Fed., 464.
In re Rome Planing Co., 96 Fed., 812.

(*c*) THE PAYMENT MUST HAVE ENABLED THE CREDITOR RECEIVING THE SAME TO OBTAIN A GREATER PERCENTAGE OF ITS CLAIMS THAN ANY OTHER CREDITOR OF THE SAME CLASS.

The record shows that J. M. Fiske & Co. obtained no "day" or "clearance" loans from any other bank than the appellant. These transactions constituted the appellant a creditor in a class by itself. The prohibition of the statute condemns prefer-

ences only when they operate to create an inequality of payment between creditors "of the same class."

There being no other creditor of this class there could be no violation of the statute.

Swarts v. *Fourth National Bank*, 117 Fed., 1.

Crooks v. *The People's National Bank*, 46 App. Div. (N. Y.), 335.

The classification referred to in Section 60*a* is not the same as that providing for priority in the payment of debts in Section 64*b* although the Special Master would seem to so assume (p. 287).

A landlord is a creditor of a different class from other creditors under Section 60*a* but he would not be entitled to priority under Section 64.

In re Belknap, 129 Fed., 646.

In re Barrett, 6 Am. Bkpcy. Rep., 199.

The holder of a note endorsed by third persons is in a different class from other creditors, under Section 60*a*.

In re Harpke, 116 Fed., 295, 297.

Almost any distinction is sufficient to constitute a separate class under Section 60*a*.

In re Denning, 114 Fed., 219, 221.

Gomila v. *Wilcombe*, 151 Fed., 470,

but the classification under Section 64 is definite and fixed.

(*f*) THE DEBTOR MAKING SUCH PAYMENT MUST HAVE INTENDED TO GIVE SUCH A PREFERENCE.

Just how far the intention of the debtor is an element in determining whether or not a preference has been given which can be set aside under the provisions of the statute has been the subject of much judicial discussion in the various Federal

Courts and has resulted in the formulation of two distinct rules.

We will not attempt to collate all the cases touching upon the subject. It will be sufficient to take a representative case of each class.

In *Alexander* v. *Redmond*, 180 Fed., 92 (C. C. A., 2nd Circuit, p. 95), Circuit Judge LACOMBE, writing the opinion of the Court, held the rule to be (p. 95) that

> "The result of the transfer and not the mental attitude of the transferor, is made the test."

While in *Hardy* v. *Gray*, 144 Fed., 922 (C. C. A., 1st Circuit), Circuit Judge PUTNAM, after a very thorough examination of the authorities, concluded that the statute

> "involves the element that the 'creditor had reason to believe a preference was intended', which could not exist unless, in fact, a preference was actually intended on the part of the debtor, or unless there existed what the law regards as the equivalent thereof" (p. 927).

This latter rule is approved and followed *In re First National Bank of Louisville* (C. C. A., 6th Circuit), 155 Fed., 100, in which case Mr. Justice LURTON, then a Judge of the Circuit Court, concurred in the opinion of Circuit Judge SEVERENS, in which it was held, following the authority of *Hardy* vs. *Gray*, *supra*,

> "That the reasonable implication of the language is that the debtor himself must have intended the preference. The very word signifies the doing of a thing with a purpose to give an advantage; and the construction which treats the motive of the debtor as indifferent seems artificial and awkward" (pp. 103-104).

These latter cases are followed and approved in the same Circuit in *Kimmerle* v. *Farr*, 189 Fed., 295; and in *In re Leech*, 171 Fed., 622; in the Circuit Court of Appeals for the Fifth Circuit, in *Tumlin* v. *Bryan*, 165 Fed., 166; and in the District Court of the United States for the Eastern District of Kentucky in *Debus* v. *Yates*, 193 Fed., 127, in which District Judge COCHRAN made a very exhaustive examination and review of the authorities.

This case coming as it does from the 2nd Circuit was expressly decided on the basis of *Alexander* v. *Redmond*.

Our examination of the authorities has led us to the conclusion that the respective merits of these two rules of interpretation have never been brought squarely before this Court, and we respectfully submit that the rule as now existing in the Second Circuit is erroneous, is not in accord with the best authorities upon the subject, is judicial legislation in that it dispenses with one of the requirements of the Act, and is not based on a sound rule of construction of the Bankruptcy Act.

It has been said that the doctrine announced in *Alexander* v. *Redmond* had been theretofore approved by this Court in *Pirie* v. *Chicago Title and Trust Co.*, 182 U. S., 438, and it might also appear from its decision in *Benedict* v. *Deshel*, 177 N. Y., 1, in which the question was squarely put and answered in the negative as to whether in a suit by a trustee to avoid a preference it was incumbent upon him to prove *the intent of the debtor* to give a preference, as well as the creditor's reasonable ground to believe that a preference was intended to be given, that the New York Court of Appeals was of the opinion that this Court had lent its approval to said doctrine.

In spite of this high authority, we are unable to agree with the New York Court of Appeals in its

interpretation of the decision in the *Piric* case, and agree with District Judge COCHRAN who, writing the opinion in *Debus* v. *Yates* (*supra*), pointed out that in rendering that opinion the State Court entirely overlooked the fact, that in the *Piric* case this court was dealing with an *obstructive* preference, and that in the case of a *voidable* preference the intent of the debtor was an element necessary to be established (193 Fed., 436).

The question in the *Piric* case was whether under Section 57*g*, a person who had received a preference of *any nature*, had to surrender it in order to prove a claim in bankruptcy. The case, however, in no way involved the question of the necessary elements which must be proved to establish the trustee's right to avoid a preference under Section 60 *b*. The difference between the requirements of the two sections is plainly recognized by Mr. Justice MCKENNA, who said (pp. 454-455):

> "It is further contended 'that to constitute a preference under the bankruptcy act within either 57 (*g*) or 60 (*a*), at least *the intent on the part of the bankrupt to prefer must be* present.' In support of this, it is said, that an act of bankruptcy consists under Section 3 (2) of a transfer by a debtor while insolvent of any portion of his property to one or more of his creditors, *with intent to* prefer such creditors over other creditors, and in such a case a petition in involuntary insolvency may be filed against him. Section 3*b*. It is hence deduced, reading those provisions with Section 60 (*a*), that preferences under the latter must be taken with the intent declared in the former, because it is not reasonable to assume that Congress intended that there could be preferences which were not acts of bankruptcy. The claim overlooks the fact that the language of Section 3 (2) implies a difference between a preference and the intent with which it is given, and besides confounds the

> different purposes of the sections and their different conditions. It was for Congress to decide whether the consequences to a debtor of being forced into bankruptcy so far transcended the consequences to a creditor by a surrender of his preference, as to make the power depend upon an intent to offend the provision of the statutes and the latter not so depend. And we see nothing unreasonable in the distinction or purpose."

All that is then decided, is that if a person who has received a preference wishes to participate further in the division of the bankrupt's estate, he must surrender the preference irrespective of whether or not he received it under conditions which would warrant a recovery by a trustee in bankruptcy.

In *In re Fixen* (C. C. A., 9th Circuit), 102 Fed., 295, approved by this Court in the *Pirie* case, Circuit Judge MORROW shows that such an interpretation would in no way interfere with ordinary transactions based on credit, and says:

> "The creditor is not compelled to surrender a payment made to him on account, in the ordinary course of business, unless he has reason to believe that his debtor is insolvent and that the payment is a preference. If the creditor is innocent in the transaction, *he has his option* to retain the payment and waive his claim to the balance of the account, or he may surrender the payment and present his claim for the whole account" (p. 299). [Italics ours.]

Referring to the *Pirie* case, District Judge LOWELL writing in the District Court of the District of Massachusetts in *In re Henry C. King Co.*, 113 Fed., 110, states:

> "That case held that the transaction was none the less a preference because the ele-

> ment of knowledge was wanting, and, if this be so, a transaction can hardly be more a preference because knowledge of insolvency is present; in other words knowledge of insolvency converts an innocent preference which may be obtained if the creditor will forego proof, into a guilty preference which may be recovered back by the trustee. But, since the element of knowledge is excluded from the definition of preference—it follows that even an innocent preference, one received without knowledge of insolvency—is still a preference, and must be surrendered *before proof*" (p. 111). [Italics ours.]

Circuit Judge PUTNAM in *In re Dickson* (*Dickson* v. *Weyman*), (C. C. A., 1st Circuit), 111 Fed., 726, declines to apply the rule of the *Pirie* case to a case where a creditor in the ordinary course of business, during the four months preceding bankruptcy received payments and gave credits on open account without any intention to acquire an unjust preference, even though the result of the transactions was to increase the net indebtedness to the creditor, and correspondingly decrease the bankrupt's estate.

The ruling of Judge PUTNAM in this latter case was approved by this Court in *Jacquith* v. *Allen*, 189 U. S., 78. That case came before the Court from the Circuit Court of Appeals for the First Circuit. It was decided below (118 Fed., 270), on the express authority of *In re Dickson* (*sub. voc Dickson* v. *Weyman*), no opinion being written.

See also the remarks of District Judge HAMMOND in *In re Wolf and Levy*, 122 Fed., 127, on the subject of the efforts to extend the authority of the *Pirie* case.

In fact the entire extent of the holding of the *Pirie* case has been stated by the learned Chief Justice in his opinion in *Jacquith* v. *Allen*, *supra*.

After analyzing the findings of fact he says, at page 82:

> "*Upon the facts* the Circuit Court of Appeals concluded as a matter of law that the payments made 'at the time and in the manner * * * shown', constituted a preference, and that by reason of the failure and refusal of Carson, Pirie and Company to surrender the preference *they were not entitled to prove their claim*" [Italics ours].

Reverting to the case of *Alexander* v. *Redmond* (*supra*) an examination of the facts will show that the same result could have been reached by applying the doctrine of *Hardy* v. *Gray* without establishing the radical rule laid down in the opinion of the learned Circuit Judge.

The facts were as follows:

Redmond & Co. for a period of two years had discounted the bankrupts (Borrn & Co.) paper. On August 12th, 1908, they bought from it a draft on London for £500 which was not accepted by the drawer when presented. Upon demanding repayment on August 29, 1908, of the amount paid on the discount, a representative of the bankrupt stated that it was not in a condition to make such refund. A conference was arranged for September 1 and as a result of that conference a written assignment was made by the bankrupts to one Thomas, a representative of Redmond & Co. of certain enumerated book accounts standing on the books of the bankrupt. At this conference there were present besides certain officers of the bankrupt, representatives of several of its large creditors and one Schnitzer, counsel for Redmond & Co. Counsel for the bankrupt informed Schnitzer on that day that Borrn & Co. were "hopelessly insolvent." The affairs of the concern were thoroughly gone over by the conferees and Schnitzer insisted on payment, saying if Redmond & Co. were not paid he would

cause Borrn & Co. to be thrown into bankruptcy. Objection was made by counsel for one of the other creditors at Redmond & Co. being preferred over his client, and Schnitzer replied that he thought they were entitled to a preference because the debt had not been long owing and Redmond & Co had made the discount under a misapprehension. After further discussion Schnitzer said: "I will take this assignment and take my chances on it, if you people will permit it to be given." Later, after the assignment had been made and counsel for the bankrupt had remarked on its probable invalidity, Schnitzer again remarked: "Well, go ahead and fix it up, and I will take my chances." Subsequently Borrn & Co. were thrown into bankruptcy and an action was brought by the trustee to set aside the assignment to Thomas as the agent of Redmond & Co. under Section 60 of the Bankruptcy Act.

We submit that these facts present a perfect case from which the Court could properly infer an intent on the part of the bankrupt to give a preference as well as a reasonable cause to believe that a preference was intended to be given on the part of the creditor.

Schnitzer, with full knowledge of the financial status of Borrn & Co. *demanded* for his clients that their debt be secured, the demand being accompanied by a threat of bankruptcy. The assignment was *given* with full knowledge of the situation and was accompanied by a statement that the same would probably be set aside if bankruptcy ensued, and was *accepted* by the creditor in the face of objection by another creditor that it constituted a preference, with the statement that they would take their chances on it.

The difficulty with the rule of the *Alexander* case is that it imposes upon the creditor the duty of determining what the effect of the transfer will be, instead of burdening him merely with the duty im-

posed by the statute which only involves deciding what the intent of the bankrupt must reasonably be supposed to be, and in so doing the case reads out of the statute one of its "reasonable implications" (*In re First National Bank of Louisville, supra*).

That this was not the law was very apparently the opinion of the Congress when it passed the Act of June 25, 1910, and amended Section 60*b*) so as to provide that

> "if, at the time of the transfer * * * the person receiving it or to be benefited thereby, or his agent acting therein, * * * shall have reasonable cause to believe that the enforcement of such * * * transfer *would effect a preference*, it shall be voidable by the trustee" (U. S. Comp. Stat. 1901, Supp. 1911, p. 1506). [Italics ours.]

Contrast this statute with the provisions prior to the amendment which specifically provided that the creditor must be shown to have reasonable cause to believe "*that it was intended to give a preference*," and it will readily be seen that the entire *modus operandi* thereunder has been changed.

The proof is now directed by the Statute to the *effect* of the transfer rather than the *motive*, and if the effect is shown and the reasonable cause of the creditor to believe that the payment would result in such an effect is shown, the statute is satisfied irrespective of the intent or motive which may have prompted the transfer.

> *Collier on Bankruptcy* (9th Ed.), p. 815.

Under the present existing statute which absolutely does away with the intent of the debtor the rule of *Alexander* v. *Redmond* that the mental attitude of the transferor is immaterial is undoubtedly correct. The difficulty with that case is that it

anticipated the amendment of 1910. If the case were sound law why should the Congress find it necessary to amend the statute? Manifestly it construes as immaterial one of the constituent prerequisites required to be proved, it is judicial legislation and in so legislating it adopts of necessity a construction which is forced and which the Circuit Court of Appeals for the First Circuit declined to adopt in *Hardy* v. *Gray* (*supra*) and it is against the weight of authority.

In the case at bar the only evidence bearing in any way upon the intent of the bankrupt is found in Mr. Roe's testimony (pp. 79-121). As pointed out by Mr. Roe he deliberately told Mr. Sherwood that he had heard rumors of his firm (pp. 92-93). And although he apparently was given every opportunity to speak, he made no direct reply to this charge involving his very right to do business (p. 93). Mr. Sherwood was called as a witness (pp. 212-214), and gave no testimony whatever on this most important phase of the transaction. The same is true of Mr. Fiske (pp. 53-71, 181-212). Mr. Sherwood's act of delivering securities to Mr. Roe, when he was under contract so to do upon demand cannot be construed as an act of silent assent. He was merely living up to his contract and knew that if he did not do so his credit, which was the most vital necessity of his business, would be instantly impaired. His consent was given only to what he could not lawfully oppose.

Wood v. *United States Fidelity and Guaranty Co.*, 143 Fed., 424.

Furthermore his silence under such circumstances cannot be construed as evidence of his intent to prefer. Such an argument was advanced

and its soundness denied by this Court in the case of a creditor whom the debtor allowed to reduce a just claim to judgment without any action on his part.

Wilson v. *City Bank*, 17 Wall. (U. S.), 473.

In re Jackson Iron Mfg. Co., Fed. Cas. No. 7153, citing

Sawyer v. *Turpin*, 91 U. S., 114.

Clark v. *Iselin*, 88 U. S., 360.

Watson v. *Taylor*, 88 U. S., 378.

Cook v. *Tullis*, 85 U. S., 322.

See also

Remington on Bankruptcy, § 1829.

(*g*) THE CREDITOR RECEIVING SUCH PAYMENT MUST HAVE KNOWLEDGE OR HAVE HAD REASONABLE CAUSE TO BELIEVE HE WAS RECEIVING A PREFERENCE.

The measure of knowledge or possession of facts sufficient to constitute a reasonable cause to believe that the existence of insolvency under these provisions of the statute has been stated in many cases.

It should be borne in mind in viewing the case at bar that the transaction took place prior to the amendment of June 25th, 1910, which changed the law so that as it now stands all transactions are examined solely from the point of view of the existence or non-existence of a reasonable cause to believe whether the transfer will *effect* a preference. As has been said by one commentator:

> "The proof is now to be directed to the effect of the transfer, rather than the intent of the debtor in making it."
>
> *Collier on Bankruptcy* (9th Ed.), p. 815.

In the case at bar the learned Special Master, after reviewing the authorities, concludes that:

> "If a preference is in fact given and the creditor knows or had reasonable cause to believe that the debtor at such time is insolvent, he will be held to have reasonable cause to believe that it was intended by the debtor to give him a preference" (pp. 287-8),

and states that his statement of the rule is based on the ruling of the Circuit Court of Appeals for the Second Circuit in *Alexander* v. *Redmond*, 180 Fed., 92.

Applying that rule he then holds that the appellant had reasonable cause to believe that a preference was intended (pp. 290-291).

The learned District Judge adopts his holding *in toto* (pp. 337, 349-350), and the same is true of the Circuit Court of Appeals (p. 516).

While our sole contention is not based on this point, for we also insist that the appellant, because of its equitable lien, had at all times the right to reduce to physical possession the cash and securities received by it, we also contend that the record does not reveal a state of facts under which the appellant can be held to have had a reasonable cause to believe that a preference was in fact intended by the brokers.

We do not understand the rule prior to the amendment of the statute to have been that if A being B's debtor, and knowing himself to be in a failing financial condition, should come to B, who was entirely ignorant of A's condition, and pay his debt, that recovery would be allowed on the ground of a preference if A subsequently, and within the statutory period fails. Yet as we view it this is practically what has been the result in the case at bar.

We do not contend that in order to satisfy the

statute that the creditor must be in possession of actual facts which will show the financial condition of the creditor. The rule unquestionably has been established that if a creditor accepts a transfer under circumstances which would lead a business man of ordinary prudence and sagacity to believe that he was being preferred by the debtor, without investigation, he will be charged with such knowledge of the debtor's intent as he would have acquired had he made such investigation, and in determining this fact each case must of necessity stand largely on its own feet.

Collett v. *Bronx Nat. Bk.*, 200 Fed., 111.
In re Klein, 197 Fed., 241.
In re The Leader, 190 Fed., 624.
In re Pfaffinger, 154 Fed., 523.
Collier on Bankruptcy (9th Ed.), pp. 816-817.

But this does not mean that mere *suspicion* of insolvency is sufficient to satisfy the statutory requirement.

As was said by Mr. Justice BRADLEY in *Grant* v. *National Bank*, 97 U. S., 80:

> "It is not enough that a creditor has some cause to suspect the insolvency of his debtor; but he must have such a knowledge of facts as to induce a reasonable belief of his debtor's insolvency, in order to invalidate a security taken for his debt. *To make mere suspicion a ground of nullity in such a case would render the business transactions of the community altogether too insecure. It was never the intention of the framers of the act to establish any such rule. A man may have many grounds of suspicion that his debtor is in failing circumstances, and yet have no cause for a well grounded belief of the fact.* He may be unwilling to trust him further;

> he may feel anxious about his claim, and have a strong desire to secure it,—and yet such belief as the act requires may be wanting. *Obtaining additional security, or receiving payment of a debt, under such circumstances is not prohibited by the law.* * * * The act, very wisely, as we think, instead of making a payment or a security void for a mere suspicion of the debtor's insolvency, requires, for that purpose, that his creditor should have some reasonable cause to believe him insolvent. He must have a knowledge of some fact or facts calculated to produce such a belief in the mind of an ordinary intelligent man" (pp. 81-82). [Italics ours.]

Upon the authority of this case Circuit Judge Sanborn writing the opinion of the Circuit Court of Appeals for the Eighth Circuit in *Powell* v. *Gates City Bank*, 178 Fed., 609, states the rule as follows:

> "Suspicion, fear and facts which arouse suspicion and fear that the debtor is insolvent and intends to prefer a creditor, in the absence of notice or knowledge of facts that give such a creditor reasonable cause to believe the insolvency or the intended preference are insufficient to avoid the latter."

See also,

Stucky v. *Masonic Savings Bank*, 108 U. S., 74.
Barbour v. *Priest*, 103 U. S., 293.
Sparks v. *Marsh*, 177 Fed., 739.
First National Bk. v. *Abbott*, 165 Fed., 852.
In re Pfaffinger, 154 Fed., 523.
Off v. *Hakes*, 142 Fed., 364.
In re Eggert, 102 Fed., 735.

Furthermore, if the only real status of the bankrupts could have been obtained from their

books, a creditor who has no right of access to those books cannot be charged with knowledge of the facts which they would reveal.

In re Wolf, 164 Fed., 448; affd. *sub. voc.*

Sharpe v. *Allender* (C. C. A., 3rd Circuit), 170 Fed., 589.

There is no evidence to show that the appellant or its officers had actual knowledge of the financial status of J. M. Fiske & Co. at any time on January 19, 1910, so in order to ascertain whether it can be brought within the operation of the rule of *Grant* v. *United States* (*supra*), an examination must be made of the surrounding circumstances.

The extent of the transactions in the financial district in New York City is so great, and the manner in which they are conducted so generally known, that the Courts will take judicial notice of it.

Louisville Trust Co. v. *Louisville, Etc., Ry. Co.*, 174 U. S., 674, 683.

Hutchinson v. *Manhattan Co.*, 150 N. Y., 250, 256.

Merchant's Bank v. *Hall*, 83 N. Y., 338, 345.

Swinnerton v. *The Columbian Insurance Co.*, 37 N. Y., 174, 189.

Agawam Bank v. *Strever*, 18 N. Y., 502, 512.

There was a sharp disturbance upon the New York Stock Exchange on the morning of January 19, 1910 (p. 162). There is no fact better recognized than the extreme sensitiveness of the entire system of credit as it exists in financial circles today.

And of all the various conditions of the trade none is more fundamental than that the ability to obtain credit at all times under certain well defined

conditions is the very life of the broker's business. The inevitable result is that nothing is more jealously guarded by the brokers than that privilege. The extension of such credit, no matter how much security or personal stability is behind it, demands of the lender as a matter of normal business diligence that it be carefully watched and protected.

It is equally the result of experience that whenever any sharp disturbance occurs in the financial market it is always productive of numerous rumors, most of which are utterly without foundation, but which generally find some plausibility in the fact that it is thought that those who they concern are dealing in or in some manner interested in the security or securities affected.

Bearing these facts in mind did then Mr. Roe's conduct on January 19th, 1910, indicate anything more than a normal business desire to protect the appellant's interests as they were entitled to be protected?

The learned Special Master found that Mr. Roe, when he received the securities, had reasonable cause to believe that the firm of J. M. Fiske & Co. were insolvent, and while Mr. Roe did not testify as to the details of the information he received from the clerk in the bank it is apparent from what he did, that upon receiving that information he believed that the firm was unable to pay its debts; that that is the only reasonable explanation of the cancelling of the "day" loan, his instructions to the clerks not to pay or certify any more cheques and the closing and balancing of the account; that the information which he received was sufficient to have led an ordinary business man to make an inquiry into the firm's financial condition and that the hurried manner in which he acted indicated clearly that he feared the firm would be unable to pay the

bank its "day" loan before three o'clock when it would have been due (pp. 290-1).

When all the surrounding circumstances are taken into consideration, and it is recalled that all Mr. Roe did was based solely on rumor, that it was a period of excitement, that under the bank's contract, as we view it, he had a right to reduce the securities to possession, and that manifestly if it had a right to their possession it was a proper time from a business point of view to have them in possession, we submit that no reasonable, well grounded cause to believe insolvency existed in the minds of the bank officers is shown. All that is shown is that Mr. Roe heard these rumors and took steps to put his bank in the best possible position if anything untoward should happen.

All Mr. Roe did was to do what he was entitled to at any moment in accordance with the contract under which the advance of credit was made, and it was entirely in accordance with the understanding and custom of the business that the "day" loans should be taken care of before the close of business hours.

The appellant was merely insisting upon the immediate performance of the contract under which the "day" loan was made. The fact that it may have been prompted to insist upon its rights because of the development of an excited condition in the financial district, its knowledge of which was based solely on irresponsible rumors, can in no way fasten upon it the knowledge requisite to satisfy the statute.

To hold that because caution prompted Mr. Roe to act on these rumors, that the appellant had a reasonable cause to believe that the insolvency of J. M. Fiske & Co. existed *as a fact* would result in establishing the gossip of the street as a basis of fixing legal rights.

The law requires a more substantial basis than this.

As said by Mr. Justice Bradley:

> "To make mere suspicion a ground of nullity * * * would render the business transactions of the community altogether too insecure." (*Grant* v. *National Bank*, *supra.*)

As has been said, each case of this nature must of necessity stand on its own feet. An examination of the facts in *In re Wolf Co.*, 164 Fed., 449; affd. (C. C. A., 3d Circuit), *sub. voc; Sharpe* v. *Allender*, 170 Fed., 589, and *In re Klein* (C. C. A., 6th Circuit), 197 Fed., 241, shows instances where *facts* were in possession of creditors who had been preferred which were far more potent in producing a reasonable cause to believe that a preference was in fact intended, and yet the Courts in both instances refused to so hold.

(*b*) THE INSOLVENT'S ESTATE MUST BE DIMINISHED AS A RESULT OF THE TRANSACTION.

The object of the Bankruptcy Act is to insure the rateable distribution of the bankrupt's estate among his creditors.

> *Pirie* v. *Chicago Title and Trust Co.*, 182 U. S., 438, 449.

Hence preferences are prohibited by the statute.

In order to constitute a preference, however, the *net result* of the transaction between the debtor and creditor must be to diminish the trust fund held for the benefit of the creditors. If the fund has either suffered no change or been augmented no preference has been given.

> "These transfers of property, amounting to preferences, contemplate the parting with the bankrupt's property for the benefit of the creditor and the consequent diminution

of the bankrupt's estate. It is such transactions, operating to defeat the purposes of the act, which under its terms are preference."

Per Mr. Justice Day in *N. Y. County Nat'l Bank* v. *Massey*, 192 U. S., 138, 147.

See, also,

Continental Trust Co. v. *Chicago Title Co.*, 229 U. S., 435.
Newport Bank v. *Herkimer Bank*, 225 U. S., 178.
Wild v. *Provident Trust Co.*, 214 U. S., 292.
Jaquith v. *Alden*, 189 U. S., 78.
In re Sagor, 121 Fed., 658.
Gans v. *Ellison*, 114 Fed., 734.
Dressel v. *North State Lumber Co.*, 107 Fed., 225.
Remington on Bankruptcy, § 1296.
Collier on Bankruptcy (9th Ed.), pp. 802-3.

An examination of the facts in the case of *Continental Trust Co.* v. *Chicago Title Co.* (*supra*), decided at the October, 1912, Term of this Court, is very helpful in determining whether the result in this case has been to diminish the bankrupt's estate.

In that case a petition in bankruptcy was filed against one Prince on February 15, 1905. For several years he had been a member of the Board of Trade of Chicago, buying and selling subject to its rules. Appellants' predecessor, the Federal Trust and Savings Bank, was engaged in the general banking business in Chicago, and Prince did his banking with that institution maintaining a general deposit and checking account therein.

By the rules of the Board of Trade purchasers

and sellers might require of the other party to the trade a deposit of 10% of the contract price of the property dealt with and further security as from time to time the margin might require.

Certain banks in Chicago of which the Federal Trust and Savings Bank was one were authorized to issue "margin certificates" in which they certified that the member of the Board of Trade giving the certificate had deposited a certain number of dollars as security on a contract or contracts between him and his vendor, which amount was payable on return of the certificate endorsed by both the vendor and vendee or else by the President of the Board of Trade.

Margin certificates were issued to Prince by the Federal Trust and Savings Bank at various times from September 15, 1904, to February 9, 1905. To procure these he had either drawn his check against his checking account with the Bank or else deposited with it the requisite sum of money.

Each certificate evidenced a liability of the Bank to Prince for the face amount thereof, unless because of his default on his contract it became payable to the other party.

On February 14, 1905, one of the Bank officers and Prince had a conference in regard to the latter's financial difficulties and one W. P. Anderson of W. P. Anderson & Co. was called in consultation. The concrete matter under discussion was as to the best method of closing out Prince's open trades, and Anderson agreed to act in the premises. Prince forthwith transferred all his open trades in accordance with the Rules of the Board of Trade, and Anderson agreed to carry out Prince's contracts and proceeded to do so. On February 15, 1905, Anderson & Co. substituted its own securities for Prince's trades and recovered and turned over to the Federal Trust and Savings Bank the certificates deposited by Prince. Prince

at that time was indebted to the Bank to the extent of about $37,000 and the Bank upon the return of the certificates by Anderson & Co. applied the money secured by the certificates to Prince's indebtedness with it. It was found that taking the open trades so transferred as a whole the condition of the market at the time of the transfer was such that the aggregate amount due Prince if he had settled would have been greater than the aggregate amount due from Prince, that the market was constantly changing on February 15th, 1905, and that if Prince had carried out all his contracts his profits and losses would have about balanced. It was also found that the plan adopted was doubtless the best plan that could have been adopted to avoid serious loss to Prince and that if Anderson had not taken charge of Prince's trades and carried them through a serious panic might have ensued.

It was held, Mr. Justice Day writing the opinion of the Court, that while the bank had reasonable cause to believe that Prince was insolvent from and after February 10, and during the transactions through and including the 15th, that the decree setting aside the payment to the bank should be reversed because the statutory element requiring a showing of a dimunition of the bankrupt's estate was wanting.

The effect of the entire transaction was explained by the learned Justice (pp. 443-4):

> "By the arrangement made, Anderson & Company took hold of the situation, and, carrying out the deals upon which Prince was bound, cleared the certificates of any obligation to others, and they thereby became payable to Prince. What was done did not in fact diminish the estate of Prince otherwise available to the creditors in the bankruptcy administration, for the traders holding them would have had the benefit of the deposits under the terms of the certificates

> and the rules of the Board of Trade. It therefore appears that this essential element of a preferential transfer within the meaning of the Bankruptcy Act, diminution of the bankrupt estate, is wanting. The fact that what was done worked to the benefit of the creditor and in a sense gave him a preference, is not enough, unless the estate of the bankrupt was thereby diminished."

In the case at bar it is established that under the method of doing business securities bought one day are deliverable the next business day and are paid for on delivery. They began business on the morning of January 19th, with a balance of $26,311.46 (p. 421). This is the amount credited on their own check book, the difference between this and the bank's balance being doubtless due to outstanding checks. The only deposit which really increased their balance that day outside the "day" loan of $100,000 amounted to $54,420.32 (credited at the bank at $54,018.08), the deposit of $73,292.75 being merely a redeposit of their own checks not delivered to the payees (p. 421).

The total aggregate of checks drawn amounted to $365,190.16 (p. 421), from which should be deducted the $73,293.75 of J. M. Fiske & Co.'s own checks drawn and redeposited. This leaves a net sum of $292,196.41 which represents the total day's business of the brokers on January 19, 1910, as shown by their own books.

If from this sum is deducted the actual balance on hand at the beginning of business amounting to $26,311.46 it will be seen that $265,884.95 of the brokers' business must have of necessity been consummated on that day with the proceeds of the "day" loan. We have not considered the deposit of $54,420.38 shown by the check book because the evidence shows that it was not received until after the account had ceased to be active.

Appendix A, hereto attached, shows that with

the exception of 20 shares of Interboro Metropolitan stock all the securities received by the appellant from the brokers were obtained either through the payment of loans, the payment to brokers for securities which they had contracted to pay for on delivery or through the substitution in loans of securities so acquired.

If we look at the situation at the opening of business before the "day" loan was made we find the broker's estate intact and him under obligation to fulfil certain contracts. To fulfil these contracts he made his "day" loan, and as a result of the transactions made with that advance of credit he was entitled to such profits, and responsible for such losses as might accrue to him, but that is a long way from the fact that he was also entitled to treat as his own property the "day" loan which was the vehicle around which these transactions were woven and which made their consummation possible.

If we examine it from another point of view the credit given for the particular purpose of allowing them to do business, increased the amount of the bankrupt's available assets by releasing to them the margin contained in the collateral loans which they paid off. Had the credit not been given, these securities would have been retained by those holding them as collateral, and would have doubtless been sold at a sacrifice. As it was, the broker was put in a position to hold the securities for a considerable time, and they were absolutely under the control and discretion of the firm or those administering it for the benefit of its creditors. The fund was thus used for the benefit of creditors generally and not to their prejudice.

FIFTH POINT.—Appellees as Trustees in Bankruptcy acquired no greater rights than had J. M. Fiske & Co.

Under the provisions of the Bankruptcy Act as it existed in January, 1910, it was well settled that a trustee in bankruptcy did not stand in the position of a *bona fide* purchaser for value. He only took such title as the bankrupt had.

Zartman v. *First Nat'l Bank of Waterloo*, 216 U. S., 134, 138.
Hurley v. *Atchison, etc., Ry. Co.*, 213 U. S., 126.
Thomas v. *Taggard*, 209 U. S., 385.
Richardson v. *Shaw*, 209 U. S., 365.
Security Warehousing Co. v. *Hand*, 206 U. S., 415.
York Mfg. Co. v. *Cassell*, 201 U. S., 344.
Thompson v. *Fairbanks*, 196 U. S., 516.

SIXTH POINT.—The books of J. M. Fiske & Co. were not properly proven so as to entitle them to be introduced in evidence to show the financial status of that firm.

The appellees attempted to prove the assets and liabilities of the bankrupt firm by offering in evidence their books, and permitting an expert accountant to testify as to what said books showed said assets and liabilities to be.

The method of proof was as follows:

Mr. Humphrey, the member of the firm who had charge and supervision of the books and also acted as Cashier was called and testified that the books were correctly kept, the entries being made in them from day to day as the transactions occurred (pp. 32-33). He was not asked to identify either the books or his own handwriting, even though he testified that he himself kept certain of them (p. 36).

Mr. Fiske another member of the firm testified that he occasionally made entries in the books, usually when work was heavy and that so far as he knew they were correctly kept (pp. 68-70).

This witness was not asked to identify either his own books or entries.

Mr. Isaacs, who had been a bookkeeper for J. M. Fiske & Co. for some years and kept some of the books (pp. 76-77) identified the Stocks Loaned and Borrowed book (p. 138), Customers Ledgers A - K and L - Z, the Purchase and Sales Book (p. 139) and Filing Blotter (pp. 139-140).

These books and several others not identified by any other witness were then exhibited to Mr. Morse, the expert accountant, who testified, over objection that the same had not been legally or properly proved, that the books exhibited to him were the books of J. M. Fiske & Co. which he had examined and from which he had compiled his statement of assets and liabilities (pp. 43-46-49, 176).

The Special Master overruled the objection to the offer of the books and allowed an exception (p. 176). He was sustained by the District Judge (p. 348). Error was duly assigned to this ruling to the Circuit Court of Appeals (p. 362) and the matter is brought before this Court on the 7th and 8th Assignment of Error (p. 523).

The books so offered and received in evidence in this manner were the following:

Private Ledger, Plaintiffs' Exhibit 18.
Customers' Ledger A to K, Plaintiffs' Exhibit 19.
Customers' Ledger L to Z, Plaintiffs' Exhibit 20.
Commodity Ledger, Plaintiffs' Exhibit 21.
Purchase and Sales Book, Plaintiffs' Exhibit 22.
Blotters, covering period Jan. 3-19, 1910, Plaintiffs' Exhibit 23.
Stock Record, Plaintiffs' Exhibit 24.
Borrowed and Loan Book, Plaintiffs' Exhibit 25.
4 Check books, Mechanics National Bank.
Predecessor of Appellant, Plaintiffs' Exhibits 26, 27, 28 and 29.

Mr. Morse distinctly stated that the only testimony he could give as to the assets and liabilities was derived from the books (p. 46).

The only witnesses who testified that they made any entries in any of the books were Messrs. Humphrey, Fiske and Isaacs.

It also appears from the testimony of Mr. Isaacs that entries were made in the books by the following persons, none of whom were called as witnesses: Messrs. Waller, Lilienthal, Cogswell, Kirschner, Endicott Fiske, Sadler and Childs (pp. 77, 138-143). Mr. Sherwood was called and his testimony is utterly barren of any inquiry in regard to the entries made by him.

None of these gentlemen were called as witnesses and no reason is given for the appellee's failure to do so.

The books were offered for the purpose of estab-

lishing bankruptcy. The only testimony as to the assets and liabilities of the firm was given by Mr. Morse, the expert accountant, whose testimony was based entirely upon what the books showed.

Although Messrs. Fiske, Sherwood and Humphrey were each called to establish their own financial condition and a stipulation as to Mr. Washburn's assets and liabilities was asked and given (pp. 181 *et seq.*; 2123; 215-6; 261) it is noteworthy that no member of the firm was asked to testify to the firm's assets and liabilities. Such evidence would have been entirely competent, and at one time or another every member of the bankrupt firm was on the witness stand.

If the appellees as trustees in bankruptcy stand in the shoes of their bankrupts then the bankrupt's books are in effect their books, and their offer by them to establish the statutory requirement of insolvency as a fact is manifestly improper because self-serving.

If, on the other hand, the trustees in bankruptcy are to be looked on as being in a position similar to the complainant in a judgment creditors action, the admission of the books is unquestionably proper, but not for the purpose of proving the existence or nonexistence of a state of insolvency. Such actions sound in fraud and the books are admitted to show the *intent* which is the basis of the fraud.

In cases in which fraud is the gravamen of the action, the courts, prompted by the inherent difficulty of proving fraud, have given a much broader interpretation to the rules of evidence than in cases where the element of fraud is not present. The reason for this policy is apparent and was very clearly explained by Judge Vann in writing the opinion of the New York Court of Appeals in *White v. Benjamin*, 150 N. Y., 258, 265-7.

> "Fraud is one of the broadest issues known to the law, for it can seldom be proved by

direct evidence, but is dependent upon circumstances which, separately considered, may be quite immaterial, but when combined are not only material but have great persuasive force. The facts in an issue of commercial fraud are frequently drawn with difficulty from hostile witnesses, whose effort is to conceal as much and reveal as little of the truth as their conscience and skill will permit. * * * Upon the trial of an issue, such as that now under review [judgment creditors action to set aside as void a general assignment for the benefit of creditors], much latitude has been allowed in modern times, not only as to the method of examination, but also as to the substance of the evidence itself. * * * In determining whether a given transaction was fraudulent, courts carefully look at the ordinary transactions of the person charged with fraud, and especially at such entries upon his books, bearing upon the subject in hand, as were made at a time when he could have had no object in manufacturing evidence. Accurate bookkeeping should present a complete history of a man's business affairs, and the entries made in the ordinary course of his business are regarded as acts and not as mere declarations. While they are not received in an ordinary action at law to recover a debt, except under peculiar circumstances, or as against the party who kept the books, in an action in equity, and especially upon the trial of what are known as 'creditors actions,' they are admitted not only against the judgment debtor, whose acts they are supposed to record, but also against those deriving title to property from him, as to such entries as were made while such property was still in his possession. * * * Although the books are not competent as against a creditor seeking to recover a judgment for his debt, they may be introduced by a judgment creditor to support an attack in equity upon the transfer of property by the judgment debtor to a third person,

> claiming a valid debt as the consideration for the transfer. Entries made in the ordinary course of business, while the debt in dispute was in process of contraction, are competent as to another creditor, for the purpose of showing that there was no such debt, or that it was materially less than the amount claimed. While such evidence is not conclusive, *it has a bearing upon the question of the intent and good faith of the judgment debtor*, as it shows how he acted or failed to act with reference to a principal fact. If the transfer attacked is defended as a preference given in consideration of a precedent debt, and it appears that the debtor in the common course of business did not regard or treat the alleged debt as genuine, it bears upon his honesty in making the transfer. Any evidence tending to establish that fact would be competent, not only as against himself, but also as against those standing in his shoes, for the motives of both parties to the acts effecting the preference are open to inquiry. Unless both acted in good faith, the preference, under ordinary circumstances, cannot stand. The good faith of the debtor, therefore, is an important element in the title of the person accepting the preference." [Italics ours.]

If this theory of the purpose of the extension of the rule is correct it is manifest that the learned District Judge was in error. In fact the case of *Adams* v. *Bowerman*, 109 N. Y., 23, cited by him in support of his ruling shows clearly that the books in that case were admitted solely as bearing on the question of the *bona fides* of the transaction and not on the issue of solvency.

The action was against a sheriff for unlawful taking. The sheriff justified under process against a firm from whom plaintiffs acquired title, alleging that that firm had acquired title by purchase on credit induced by false representations of financial standing. The Referee excluded the books of the

plaintiff's predecessor in title upon the ground that they were hearsay. The issue was as to the knowledge or lack of knowledge of the firm in question as to the fraud and the Court held the exclusion of the books to be in error because they were admissible upon whether the firm *knew of the fraud.* As was said by Judge Danforth:

> "As between them and the vendors, the sale, if obtained *by fraud* was invalid, and *bearing upon that question,* the evidence was clearly competent and material" (p. 31). [Italics ours.]

If the books are to be considered as being offered to prove bankruptcy we can find nothing in the law which relaxes the ordinary rules governing the proof of books. As we have pointed out there is no question of actual fraud in this case, and while the books may in a measure be some evidence of the intent of the debtor, the proof of which is required by the statute, to claim that the books are not introduced to show the existence or nonexistence of assets and liabilities and to show what transactions the firm was to receive the benefits of and be liable upon is futile, because without them the proof of bankruptcy is palpably inadequate.

We can see no reason in principle for differentiating the requirements of the rules of evidence in this case from the cases where services, delivery or payment are sought to be proved by book entries, and submit that none exists.

The "shop-book" rule is of great antiquity. It was originally laid down in New York State in *Vosburgh* v. *Thayer,* 12 Johns, 461, in which it is stated that

> "They [tradesmens' books] ought not to be admitted when there are several charges, unless a foundation is first laid for their admission, by proving that the party had no clerk, that some of the articles charged have

> been delivered, that the books produced are the account books of the party, and that he keeps fair and honest accounts, and this by those who have dealt and settled with him" (p. 462).

The rule has been followed in many cases, among them

> *Swan* v. *Warner*, 197 N. Y., 190.
> *Smith* v. *Smith*, 163 N. Y., 168.
> *McGoldrick* v. *Traphagen*, 88 N. Y., 334.

Rathbone v. *Hatch*, 80 App. Div., 115 in which it is applied to stock brokers' books and the requirement of the rule that it must be proved that the brokers kept fair and honest books, by a person who has dealt and settled with them on the basis of their books, is held not to have been complied with.

Although Mr. Fiske and Mr. Humphrey testified that their (J. M. Fiske & Co's.) books were correct and although Mr. Isaacs, who it is true was their clerk but who was never shown to have dealt with them on the basis of the books, testified that the entries were correct, and although Mr. Morse testified that the books contained *bona fide* transactions which his investigations led him to believe were recorded correctly, we submit that the rule of the *Vosburgh* case has not been satisfied.

The only specific evidence to be found as to the source of the entries in the books is Mr. Isaacs' testimony. He was a bookkeeper in the employ of the bankrupts and personally kept the stock ledgers, the customers' ledgers (p. 76), the clearing house blotter and the trial balance book (p. 77). Mr. Humphrey kept the cash blotter (p. 77) and the check books (p. 36). One Harry Waller kept the long and short book (p. 77) and various other persons about the office made entries from time to time (pp. 142-144). The witness made no

original entries in the books kept by him at all (p. 142). His source of information was the blotter kept by Mr. Humphrey and such blotter entries as he made were taken from the purchase and sales book (pp. 144-145). He had no source of information as to their correctness other than as shown by his balances (p. 145).

This Court in *Chaffe & Co.* v. *United States*, 18 Wall. (U. S.), 516, held that in such a case for the entries to be admissable the rule required

> "not merely that they shall be contemporaneous with the facts to which they relate, but shall be made by parties having personal knowledge of the facts, and be corroborated by their testimony, if living and accessible, or by proof of their handwriting, if dead, or insane, or beyond the reach of the process or commission of the court" (p. 541).

See also *Chicago Lumbering Co.* v. *Hewitt* (C. C. A., 6th Cir.), 61 Fed., 314, in which Mr. Justice Lurton, then a Circuit Judge discusses this phase of the rule.

The facts in that case show an identification of books almost exactly similar to that in the case at bar, and for the error committed in their admission the judgment was reversed and a new trial ordered.

Plaintiff in error, had a saw mill near the mouth of the Manistique river in Michigan. About two miles above the mill of the appellant, defendants in error owned a mill called the "James". There was a boom across the river above each mill. The Indian river emptied into the Manistique between the two mills. Defendants in error owned lumber lands on both the Manistique and Indian rivers above plaintiff in error's mill. Defendants in error were having their logs, which were floated down both rivers, sawed at the "James" mill. Defendants in error made an oral bargain with plaintiff in error that it would saw and pile on its dock for shipment all

logs which should escape from the "James" boom into the plaintiff in error's boom and all logs which the "James" mill could not saw and which the defendants in error should pass into their boom. Defendants in error's evidence tended to show that during the winters of 1879 to 1883 inclusive they had cut and put into the Manistique and Indian rivers, according to the scale of logs made in the woods 15,346,191 feet board measure, that the logs were driven down the rivers, that the drives were what the lumbermen called "clean" drives and that not over 1% were hung or sunk. The evidence also tended to show that the amount of lumber cut at the "James" mill during that period was 11,036,176 feet and the amount received from the plaintiff in error 2,119,000. Defendants in error claimed they were entitled to recover for an amount of lumber equal to the difference between the wood scale and the amount they received from the "James" mill and the plaintiff in error, amounting to 2,190,715 feet.

For the purpose of showing the quantity of logs put into the river above the boom of the plaintiff in error, defendants in error called one McFadden who had been a foreman at a lumber camp of the defendants in error on the Indian river in the winters of 1879-1880. He testified that the logs cut at that camp and put into the stream had been scaled by one Foley, that the duty of the witness was to see they were scaled in good order, that Foley kept a tally of his scales upon tally boards hung on a piece of wire and that every evening he and Foley would figure out together from the tally boards the quantity of logs so scaled, and enter the same in a book, that he often examined Foley's scaling three or four times a day and that the book gave the tally of the logs scaled.

The book was offered in evidence and admitted over objection on the ground it was hearsay and incompetent.

Held. Error.

"It is true that the book is one which had been kept by the witness, and the entries offered had been all made by him. But it is equally true that the data upon which those entries had been made had been obtained from another, and that the witness had no such personal knowledge as to the correctness of these data as to enable him to say anything more than that he had correctly recorded the results obtained from data furnished by another. * * * The mere fact that a temporary entry is made on a slate, or by chalk scores, or, as in this case, by pencil memoranda on tally boards, for the purpose of convenience and aiding the memory until a book entry could be made at the close of the day, would not operate to deprive such subsequent entry of the character of an original entry, nor the book in which it was made of its character as an original book of accounts. * * * The original rough memoranda are not books of original entry, and need not be produced; and the fact that such memoranda had been made to aid the memory until a formal entry could be made will not make the book into which they were at once transcribed secondary evidence. * * * *The difficulty in this case lies in the fact that the book entries were made from the tally-board memoranda by a person other than the one who made the tally-board entries, and who knew nothing of the correctness of the data transcribed. That McFadden was able to testify that his additions were correct, and that he had correctly entered the sums thus ascertained, is not enough.* * * * What McFadden knew was that Foley, whose duty it was to scale the logs put in the river each day from that camp, had by his tally-board memoranda reported a given number of logs, containing, when aggregated, a given number of feet, as having been set afloat on a particular day. If McFadden had made his entries from oral statements made by persons having

knowledge of the number and contents of logs floated each day, such entries would not have been competent without calling the persons who knew the facts, and on whose authority the entries had been made. Is there any distinction in the evidential value of entries made on the oral statement of clerks or servants who know the facts and memorandum made for convenience in aiding the memory of such clerks or servants? *We can see none*" (pp. 316-317). [Italics ours.]

SEVENTH POINT.—The decrees of the United States District Court for the Southern District of New York, granting the relief prayed for in the bill of complaint and affirming said decree in accordance with the mandate of the United States Circuit Court of Appeals for the Second Circuit should be reversed.

New York, N. Y., September 22d, 1913.

Respectfully submitted,

ADRIAN H. LARKIN,
Solicitor for Appellant.

ADRIAN H. LARKIN,
LEWIS H. FREEDMAN,
LELAND B. GARRETSON,
Of Counsel.

Tabulation Showing How J. M. Fiske & Co. Secured Posse uary 19, 1910, Set Forth in Plaintiff's Exhibit 6 (p. 38 Fiske & Co. Covering Transactions of that Day (Plainti

Securities delivered Defendant, as shown by Exhibit 6.	Certificate Nos.	Mechanics' Bank Chk. Nos.	Payee of Mechanics'
20 M. Wabash 1st Rfg. 4s.....	9810 22875	59547	G. Sidenburgh
	12034 22876		
	16468 22877		
	16469 28852		
	16470 28853		
	20744 28854		
	20746 30931		
	20748 30932		
	22869 30933		
	22871 30934		
10 shs. Inter-Met. Com.....	T. 3516	.....	.....
100 shs. North American.....	38054	.....	.....
900 shs. M. K. & T. Com.....	A- 01124- 10 shs.	59541	T. L. Manson &
	B- 019273- 20 "	"	"
	B- 019040- 20 "	"	"
	B- 018760- 50 "	"	"
	025171-100 "	"	"
	028002-100 "	59539	J. L. Graham
	027663-100 "	59548	National City Ba
	026575-100 "	"	"
	025464-100 "	"	"
	026603-100 "	"	"
	026429-100 "	"	"
	026820-100 "	59547	G. Sidenburgh
100 shs. Kerr Lake Mining Co....	T- 2300	59528	Dominick & Dom
200 shs. Utah Copper.....	T- 11973-100 "	59548	National City Ba
	12038-100 "		
400 shs. Columbus & Hocking Coal & Iron Co.....	4586-100 "	59548	National City Ba
	T- 4751-100 "	59550	Lathrop Haskins
	5521-100 "	"	" "
	T- 5558-100 "	59549	" "
100 shs. Chicago Union Traction Co. (Certificate of Deposit)....	A- 1958	.....	.....
100 shs. Northern Pacific.....	C- 39882- 50 "	59548	National City Ba
	C- 40058- 50 "	"	"
400 shs. Great Northern Pfd.....	A- 796668- 50 "	59548	National City Ba
	A- 80851- 50 "	"	" "
	69460-100 "	"	" "
	67271-100 "	"	" "
	67272-100 "	"	" "
200 shs. U. S. Steel Com.....	G- 324921-100 "	59551	Mechanics Natio
	G- 324922-100 "	"	" "
100 shs. Am. Car & Foundry Co..	33869	59542	E. & C. Randolp
10 shs. Sloss-Shef. Steel & Iron Co.	B- 7244	59551	Mechanics Natio
10 shs. Chicago & Alton.....	A- 1387	59551	Mechanics Natio

NOTE 1: *100 shs. North American, Ctf. No. 38054;*
The Blotter of J. M. Fiske & Co. (Plaintiff's Exhibit 23), shows that when said firm paid to National City Bank
and Iron Co. common stock represented by certificate 4089. This stock was substituted for the above named stock

NOTE 2: *100 shs. Utah Copper, Ctf. No. 12038;*
100 shs. Chicago Union Traction Co., Ctf. of Deposit A-1958:
The Blotter of J. M. Fiske & Co. (Plaintiff's Exhibit 23), shows that when said firm paid the National City Bank
Coal and Iron Co. common stock represented by certificate 5329. This stock was substituted for 200 shs. of Central
10 shs., and B-13814 for 20 shs. in the loan which said firm had outstanding with Central Trust Co. of New York.
said firm had outstanding with the Lincoln Trust Company.

APPENDIX A.

ing How J. M. Fiske & Co. Secured Possession of the Securities Delivered to the Defendant on Jan-. Set Forth in Plaintiff's Exhibit 6 (p. 381). Compiled from the Check Book and Blotters of J. M. vering Transactions of that Day (Plaintiff's Exhibits 23 and 27).

shown	Certificate Nos.	Mechanics' Bank Chk. Nos.	Payee of Mechanics' Bank Check.	Amount of Check.	Method of acquiring securities.
.....	9810 22875 12034 22876 16468 22877 16469 28852 16470 28853 20744 28854 20746 30931 20748 30932 22869 30933 22871 30934	59547	G. Sidenburgh	$25,002.25	Payment of Collateral Loan.
.....	T. 3516	.....	.....	.....	Dep. by J. J. McGraw for Margin.
.....	38054	.....	.....	.....	From Chase Natl. Bk. Loan by Substitution (*Note 1*).
.....	A- 01124- 10 shs.	59541	T. L. Manson & Co.	$9,000.00	Stock purchased.
	B- 019273- 20 "	"	"		" "
	B- 019040- 20 "	"	"		" "
	B- 018760- 50 "	"	"		" "
	025171-100 "	"	"		" "
	028002-100 "	59539	J. L. Graham	$4,500.00	" "
	027663-100 "	59548	National City Bank	$100,022.22	Payment of Collateral Loan.
	026575-100 "	"	"	"	" " " "
	025464-100 "	"	"	"	" " " "
	026603-100 "	"	"	"	" " " "
	026429-100 "	"	"	"	" " " "
	026820-100 "	59547	G. Sidenburgh	$25,002.25	" " " "
6....	T- 2300	59528	Dominick & Dominick	$900.00	Stock purchased.
.....	T- 11973-100 "	59548	National City Bank	$100,022.22	Payment of Collateral Loan. From Lincoln Tr. Co. by Substitution. (*Note 2.*)
king	12038-100 "				
.....	4586-100 "	59548	National City Bank	$100,022.22	Payment of Collateral Loan.
	T- 4751-100 "	59550	Lathrop Haskins & Co.	$15,002.08	Stock Purchased.
	5521-100 "	"	" " " "	"	" "
	T- 5558-100 "	59549	" " " "	$8,900.00	" "
tion					
.....	A- 1958	.....	.....	.....	From Lincoln Trust Co. by substitution. (*Note 2.*)
.....	C- 39882- 50 "	59548	National City Bank	$100,022.22	Payment of Collateral Loan.
	C- 40058- 50 "	"	"	"	" " " "
.....	A- 796668- 50 "	59548	National City Bank	$100,022.22	Payment of Collateral Loan.
	A- 80851- 50 "	"	" " "	"	" " " "
	69460-100 "	"	" " "	"	" " " "
	67271-100 "	"	" " "	"	" " " "
	67272-100 "	"	" " "	"	" " " "
....	G- 324921-100 "	59551	Mechanics National Bank	$15,002.08	Payment of Collateral Loan.
	G- 324922-100 "	"	" " "	"	" " " "
Co..	33869	59542	E. & C. Randolph	6,600.00	Stock purchased.
Co.	B- 7244	59551	Mechanics National Bank	15,002.22	Payment of Collateral Loan.
....	A- 1387	59551	Mechanics National Bank	15,002.22	Payment of Collateral Loan.

. No. 38054;
e & Co. (Plaintiff's Exhibit 23), shows that when said firm paid to National City Bank loan of $100,022.22 (Check No. 59548) that bank delivered among other securities 100 shs. of Columbus and Hocking Coal represented by certificate 4089. This stock was substituted for the above named stock in the loan which said firm had outstanding with the Chase National Bank.
o. 12038;
tion Co., Ctf. of Deposit A-1958;
e & Co. (Plaintiff's Exhibit 23), shows that when said firm paid the National City Bank loan of $100,022.22 (Check No. 59548) that bank delivered, among other securities, 100 shs. of Columbus and Hocking tock represented by certificate 5829. This stock was substituted for 200 shs. of Central Leather Co. stock represented by certificates Nos. C-1005 for 100 shs., B-14236 for 50 shs., B-14471 for 20 shs., B-14459 for s. in the loan which said firm had outstanding with Central Trust Co. of New York. The 200 shs. of Central Leather Co. stock so released was then substituted for the above named stock in the loan which ith the Lincoln Trust Company.

APPENDIX B.

Tabulation showing the source of the checks constituting the deposit of $54,048.18 made by J. M. Fiske & Co. on January 19, 1910, the securities for which they received said funds and the original purchase of the securities so delivered, with the source from which J. M. Fiske & Co. procured the funds with which to purchase said securities. Compiled from the extracts of the check book and blotter of J. M. Fiske & Co. printed in the record (Plaintiffs' Exhibits 23 and 27), and from the books of J. M. Fiske & Co. in evidence but not printed.

Drawer of Check Deposited Exhibit 27. P. 421.	Amount.	Securities Delivered against Check Exhibit 23 (P. 411-3).	Certificate numbers of Crtf. delivered.	Source of acquisition by J. M. Fiske & Co. of crtf. del'd.	Date of acquisition by J. M. Fiske & Co.	Mechanics' Bk. check No. Del'd on purchase.	Payee of Check.	Amount of Check.	Remarks.
S. B. Chapin & Co....	$8,400.00	100 shs. U. S. Steel @ 83-7/8.....	G-315960	Taylor Smith & Evans through Clearing House.....	Jan. 19, 1910	59534	Taylor Smith & Evans.	$8,400 00	
S. B. Chapin & Co....	6,668.75	100 shs. Pennsylvania @ 133-1/4..	Odd Lots 40 shs. A-324941; 14 shs. 321828; 20 shs. A-324881; 6 shs. A-302826; 18 shs. A-323176; 2 shs. A-831334	Strong Sturgis & Co. through Clearing House.....	Jan. 19, 1910	59535	Strong Sturgis & Co...	6,650.00	While blotter shows deliveries of "odd lots" it shows rec't of ctfs. indicated. It also shows them to be the only transaction in Penn. on Jan. 19-'10
Muller & Nash.....	975.00	210 shs. Youkon @ 4-7/8 & Com.							
	48.75	& Tax	10 shs. D- 9920 50 " D- 11620 30 " D- 10940 20 " D- 13230 100 " C-141445	From Box Jan. 19-10..					
S. B. Chapin & Co....	19,375.00	100 shs. Union Pacific @ 193-5/8..	No. 196056 Rec'd. (*(Note*) No. 176556 Del'd. (*1)*	J. J. Manning.....	Jan. 19, 1910	59545	J. J. Manning.....	19,362.50	
De Coppet & Doremus	205.00	10 shs. Boston Copper @ 20-1/2 & Com. & Tax.....	7 shs. -20013 2 " -19754 1 " -18238	From Box Jan. 19/10 De Coppet & Doremus.....	Dec. 20, 1909	58599	De Coppet & Doremus.	230.00	Mech. Bank Loan Dec. 20-09, $400,000 Bal.
C. M. Schott.....	370.00	10 shs. Tenn. Copper.....	H. 1761	From Box Jan. 19-10 C. M. Schott & Co...	Dec. 30, 1909	58847	C. M. Schott & Co.....	391.25	Mech. Bank Loan Dec. 30-09 $40,000 —Bal. $29,819.50—Payment on check stopped (*Note 2*)
Carlisle M. & Co.....	1.25	10 Missouri Pacific rights.....	$360-3801	From Box Jan. 19-10 S. W. Adler.....					
" " " "	2.50	20 " " "	$500-1598						
F. Barrell & Co.....	5,000.00	Cash			Jan. 5, 1910				
C. Fairchild Co.....	600.00	100 shs. Wheeling & Lake Erie....	6152	From Jan. 19-10 F. Grossmeyer for margin.....					
Carlisle M. & Co.....	72.13	1 sh. Missouri Pacific.....	A-44012	From Box Jan. 19-10 S. W. Adler..... ...	Jan. 5, 1910				
G. S. Kerr.....	200.00	Cash							
C. M. Schott.....	2.00	"	.....	....	.. ..	.....	.....	.....	Payment on check stopped (see note 2)
Allen McG. & Co.....	8,100.00	100 shs. Reading.....	N-10417	A. H. Coombs.....	Jan. 19, 1910	59552	A. H. Coombs..... ...	8,050.00	
Libaire & Cooke.....	4,400.00	100 shs. Central Leather.....	C-9750	S. B. Chapin & Co	Jan. 19, 1910	59533	S. B. Chapin & Co.....	4,373.00	
Total.....	$54,420.38							$47,456.75	

NOTE 1: On p. 410 of the record it appears that J. M. Fiske & Co. received from J. J. Manning 100 shares of Union Pacific represented by certificate No. 196056. On p. 411 they are shown to have delivered on the same day to S. B. Chapin & Co. 100 shares of the same stock represented by certificate No. 176556.

An examination of the books of J. M. Fiske & Co. shows that aside from the stock received from J. J. Manning they neither had nor received on January 19, 1910, any other shares of Union Pacific and delivered no other shares of that stock than those delivered to S. B. Chapin & Co.

In view of Mr. Morse's testimony (pp. 43-5) to the effect that he examined J. M. Fiske & Co.'s books, that he found that they represented general transactions and that he confirmed the transactions with the persons with whom they were had it is manifest that the certificate numbers in the blotter sheets referred to were erroneously transcribed by the clerk keeping that book.

NOTE 2: Mr. Roe, the cashier of the appellant, testified that the total of this deposit amounted to $54,048.18 (p. 80). Although the record does not explain the variation between the check book entry (*supra*), and the amount credited by the bank, the variation is capable of explanation from the bank's record, and for the sake of clarity we will account for the difference. When the deposit came in it was found that payment had been stopped on the checks of C. M. Schott aggregating $872.00. The deposit was also subject to collection charges of 20 cents, making total deductions from the deposit as originally made up of $872.20. In no event is any claim made here for a greater sum than $54,048.18.